The Sale of Promissory Notes in British Columbia by Principal Group Ltd.

Public Report No. 28

October 1991

Ombudsman

Fairness for all in British Columbia

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OMBUDSMAN

Legislative Assembly
Province of British Columbia

Please respond to:

☐ 8 Bastion Square
Victoria, British Columbia
V8W 1H9
Telephone: (604) 387-5855
Long Distance:
(toll free) 1-800-742-6157
FAX: 387-0198

☐ 202, 1275 West Sixth Avenue
Vancouver, British Columbia
V6H 1A6
Telephone: (604) 660-1366
Long Distance:
(toll free) 1-800-972-8972
FAX: 660-1691

October 1991

THE SALE OF PROMISSORY NOTES IN BRITISH COLUMBIA BY PRINCIPAL GROUP LTD.

PUBLIC REPORT NO. 28

OVERVIEW

On August 10, 1987 the directors of Principal Group Ltd. (PGL) voluntarily assigned the company into bankruptcy.

The Trustee in Bankruptcy in a Preliminary Report issued pursuant to section 141 of the Bankruptcy Act (Canada) stated:

> Prior to 1981, the main function of Principal Group Ltd. was to supply services to the subsidiary companies for a fee, which was more than adequate to cover the costs of these services. This function continued to the date of bankruptcy. Approximately $5 million of claims in bankruptcy arise strictly from trade debt.
>
> In 1981, the company increased its efforts to raise capital for its subsidiary and affiliated companies through the sale of promissory notes[1] to individuals and organizations of various types. The purchasers of these notes approximated $87.0 million of the $93.0 million of creditors' claims at the date of bankruptcy.

Table 1, attached to the Trustee's Report, shows that at the time of bankruptcy there were 496 outstanding notes (157 of which were held by British Columbians) representing total proven claims of $86,597,109.95. Of this amount $67,282,973.02 was due Alberta noteholders, $15,269,492.44 was due B.C. noteholders, $2,367,706.38 was due other Canadian

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[1] "Promissory Note" is not defined in the British Columbia Securities Act. It is, however, defined in Part IV of the Bills of Exchange Act, R.S.C. 1985, CB-4 at s.176(1)

> "A promissory note is an unconditional promise in writing made by one person to another person, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer."

noteholders, and $1,676,938.11 was due U.S. noteholders.

The Office of the Ombudsman became aware of the privately controlled company, PGL, in the context of its investigation into the regulation of First Investors Corporation Ltd. (FIC) and Associated Investors Canada Ltd. (AIC) by the Office of the Superintendent of Brokers.

On October 5, 1989, we received a formal request from the Trustee in Bankruptcy for PGL asking this office to investigate the circumstances surrounding the sale in British Columbia of PGL promissory notes. As a result our office has examined the role played by the Office of the Superintendent of Brokers with respect to the sale of these notes in British Columbia.

The factual basis for this report comes primarily from two sources: the extensive document search and analysis done on material from the files of the Office of the Superintendent of Brokers (initially done for Public Report No. 19, The Regulation of AIC Ltd. and FIC Ltd. by the B.C. Superintendent of Brokers, September 1989) and information provided by PGL's Trustee in Bankruptcy.

As well as reviewing the documentary material, we have solicited written responses to certain key questions from sixteen individuals who were employed in various capacities by the Office of the Superintendent of Brokers, and conducted personal interviews with five of them. We would like to mention that at all times throughout this investigation we have received the complete cooperation of the past and present employees of the Office of the Superintendent of Brokers and of officials from the Ministry of Finance and Corporate Relations. We would also like to acknowledge the considerable efforts of Ombudsman Officers Michael A. Ross and Patricia Anderson, who were the lead investigators for this study.

As will become evident, the regulatory regime of the B.C. Securities Act, under which promissory notes were sold, was significantly different from that which regulated the sale of investment contracts in British Columbia. The sale of investment contracts was regulated under the Investment Contracts Act which required companies selling these investment products to register and, among other obligations, to provide annual audited financial statements. Under this statute the Office of the Superintendent of Brokers had a duty to monitor the financial viability of a registered company as well as to ensure that the other statutory provisions were followed.

With respect to the sale of promissory notes the situation was different. If the sale of these notes fit an available exemption from the registration and prospectus provisions of the Securities Act, then the Office of the Superintendent of

Brokers had no duty to regulate or even monitor the sale of those notes. In fact, with the exception of a very few notes sold by PGL, the company was not even obliged to inform the Superintendent of Brokers before, during, or after the sale.

It should also be noted that the records of the Office of the Superintendent of Brokers disclose no complaints from investors that, prior to its bankruptcy, PGL failed to meet its obligations.

Notwithstanding the regulatory scheme with respect to promissory notes and a general absence of statutory duty to regulate their sale, two factors are clear:

(1) at some point prior to the bankruptcy of PGL, B.C. regulators became aware of the sale of these notes in B.C., and

(2) many of the persons who bought PGL promissory notes on the exempt securities market were not the "sophisticated investors"[2] for whom these exemptions were created.

The tragedy of many of the PGL noteholders is distressingly simple: they bought a financial product without knowing the risks involved and they lost most of their money. How and why this came to pass is the focus of this Public Report.

The Report is divided into six chapters. In chapter I, we begin with an outline of the Principal Group of Companies, explain how the promissory notes were sold in British Columbia, and present a profile of PGL noteholders.

Chapter II provides a philosophical outline of the role of securities regulation. The chapter begins by briefly tracing the history of securities regulation, goes on to deal with the methods employed for regulating the securities market and focuses chiefly on the cornerstone of modern securities regulation - disclosure.

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[2] "Sophisticated investor" is a term used to describe an investor who is deemed, because of knowledge or experience, to be able to appreciate and evaluate the risk involved in a financial purchase. Because of this "deemed" sophistication such purchasers are not thought to need regulatory protection.

Chapter III examines the legislation under which PGL sold its promissory notes. The chapter begins with a general outline of the Securities Acts under which the notes were sold and examines in detail the two exemptions pursuant to which PGL sold its notes in British Columbia. It concludes with a review of the Superintendent's power to remove these exemptions under certain conditions.

Chapter IV examines the knowledge acquired by the Office of the Superintendent of Brokers' staff with respect to the sale of promissory notes in B.C.

Chapter V provides our analysis of the foregoing information with respect to the issue of whether or not the staff of the Superintendent of Brokers' office dealt with the issue of PGL note sales appropriately.

In Chapter VI, we present our recommendations with respect to the preceding analysis.

Our general conclusion is that the B.C. regulators did not act unreasonably in their handling of the PGL note sales in British Columbia. While we appreciate the tragedy of the losses suffered by the investors in PGL notes, we cannot attribute their losses to action or lack of action on the part of the Superintendent of Brokers office. For the reasons set out in the report, there was no statutory duty to regulate the sale of PGL notes and there was no substantive failure on the part of the Office of the Superintendent of Brokers with respect to the marketing of PGL notes in British Columbia. This being the case, we cannot find that the government has a duty to compensate British Columbia investors in PGL notes.

However, our investigation has revealed that PGL was able to rely on the wording of the statute to take advantage of a group of people not contemplated by the legislators. Clearly, the legislative assumption that possession of a specified minimum amount of money to invest equals a sophisticated knowledge of financial investment was, in this situation, incorrect.

It is not the role of the Ombudsman's office to draft public policy, as this is properly the role of the legislators. However, where an investigation into the administration of a statute indicates that the legislative intention is not being achieved, it is the responsibility of this office to make

recommendations for changes to legislation and administrative practices which will correct the inadequacy. The recommendations made in Chapter VI are intended for this purpose, with the hope that a similar tragedy might be avoided in the future.

Stephen Owen

Stephen Owen
Ombudsman

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I. THE SALE OF PGL NOTES IN B.C.

1. THE COMPANY AND ITS AFFILIATES

"The Principal Group" is a term commonly used to refer either to Principal Group Ltd. (PGL) or to the Principal Group of Companies. The latter was a group of almost 40 companies operating in Canada and the United States; the former was one of those companies. PGL, originally registered in B.C. on January 2, 1967, began in the early 1980's to sell promissory notes on the exempt securities market in B.C. These notes were sold by sales people employed by Principal Consultants Ltd. (PCL) in premises attached to Principal Savings & Trust offices (PS&T). PCL was 100% owned by PGL and PS&T was 95% owned by PGL.

PGL, however, was itself 100% owned by Collective Securities Inc. (CSI). At the apex of this hierarchy of companies was Collective Securities Ltd. (CSL) which owned 80.5% of CSI. CSL in turn was 100% owned by Donald M. Cormie, the controlling force of the whole group of Principal companies.

2. HOW THE NOTES WERE SOLD

As Chapter V of our Report on The Regulation of AIC Ltd. and FIC Ltd. noted, the 1970's and 1980's were a time of rapid change in the financial sector. During this period, financial "centres" grew in popularity as there was a merging of services which had previously been separately provided by institutions known as the "four pillars": banks, insurance companies, trust companies and securities dealers.

As a wide range of services became available in one location, the risk increased that potential investors might become confused about the nature and security of the financial products available. The apparent safety of entering an institution which displayed a Canada Deposit Insurance Corporation (CDIC) decal on its door could lull an investor into believing that any product purchased within would be CDIC insured. In the case of Principal financial centres or PS&T branches, it appears that the practice was to steer would-be investors to the Principal "consultants". These consultants were part of PCL - the sales arm for all Principal financial products. They sold promissory notes, investment contracts, mutual funds and guaranteed investment certificates.

PCL sales personnel received commissions on their sales and the rate of commission varied with the type of investment

purchased. For instance, while a consultant made $1.50 per thousand dollars in a PS&T sale (which investment would have been protected by CDIC coverage up to $60,000[1]) the commission ranged from $3.00 to $6.00 per thousand dollars for other types of investments sold.

Following the collapse of AIC and FIC (both wholly-owned subsidiaries of PGL), the British Columbia Minister of Finance and Corporate Relations ordered an inquiry under the Trade Practice Act into the sales practices employed by Principal sales people. This inquiry was conducted by Lyman Robinson, Q.C. The testimony presented at the Robinson Inquiry indicated that many investors were under the mistaken assumption that their investments were guaranteed. Some believed that their investments were guaranteed by a bank, some by other Principal companies, some by the CDIC and even some by the Alberta Government.

Mr. Robinson reported that virtually all the newspaper advertisements submitted to his Commission pertaining to investments offered by the Principal Group of Companies related to interest rates offered by Principal Savings & Trust Company, and that many investors advised him that these advertisements drew them to visit a PS&T branch office. The advertisements usually contained the statement: "Member of Canada Deposit Insurance". A decal with the same message was prominently displayed on the Trust Company premises. Other member companies of the Principal Group had offices on the same premises as the Trust Company or adjacent to it. There was no distinction made to highlight the fact that only the Trust Company deposits were afforded the protection of that coverage.

Once persuaded to purchase a promissory note, a person completed a form on which the purchase application and an application to open a chequing account in Principal Savings & Trust were set out. A client could assume, in error, that the funds were backed by CDIC because all interest and maturity payments were paid into the Principal Savings and Trust chequing account in the investor's name. The applicant for a note purchase signed as an "applicant" on the form, but

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[1]The CDIC coverage was $20,000 until 1983 when the coverage was raised to $60,000.

[2]Lyman Robinson, Q.C., Report to the Minister. In the matter of the Trade Practice Act R.S.B.C. 1979, c.406 and In the matter of First Investors of Canada Ltd., Principal Consultants Ltd., Principal Savings & Trust Co. Ltd. and Principal Group Ltd., October 14, 1987, pp.15-17.

applied for a bank account and signed as "depositor" on the bottom section of the form. Notwithstanding this, the forms did clearly state in the middle section: "Principal Group Ltd. noted are not covered by Canada Deposit Insurance Corporation".

Records of the Principal Group indicate that an action plan was established by the Company in March 1985 to increase the sales of PGL notes; this goal was to be accomplished by increasing both the number of consultants selling the notes and the quantity sold.

In order to attract more investors as well as investors living outside of the province of Alberta, the company believed it needed a "glossy" annual report. Consequently, the 1985 Annual Report of PGL was designed as a tool in promoting the sale of promissory notes. The campaign aimed to encourage the sale of longer term notes and so in July 1985, the company increased the commission payable to its agents from $3.00 per thousand to $6.00 per thousand for PGL notes of a duration longer than one year. Commissions on shorter term notes remained the same.

In January 1986, PGL introduced a "hold rate policy" whereby a rate incentive was provided to clients who had money maturing between January 3, 1986 and March 3, 1986. The policy applied to all term and PGL note products. As well, a 1 1/2% spread between PS&T term deposits and PGL notes of one to five years duration was established, thus offering a further investor incentive to purchase PGL notes rather than CDIC-protected deposits.

The company went so far as to provide a "hot line" so that a consultant could arrange an even more competitive rate for certain clients; in addition, the company offered a self-administered RRSP with all fees waived for those clients who purchased a minimum of $50,000 in PGL RRSP promissory notes.

Reporting moderate success in its campaign, the company determined a rate curve in April 1986 since they felt that sales of 2, 3, 4 and 5 year notes were "...not as high as they should be". They proposed that the rate curve in interest would "...increase the likelihood that one year clients will go five years".

This concerted campaign to promote promissory note sales was described in a company memorandum dated August 25, 1986:

> As you know, one of our primary objectives is to increase PGL note sales. Our efforts in this direction have been successful so far in 1986 and we anticipate even greater success in the future...

> In order to help your client management, I have attached a list of all "former" PGL Note clients who have been assigned to you. Possibly you may have seen a similar list earlier in the year, or may have prospected a number of these clients already. It is important that you satisfy yourself that all these former clients have been contacted about investing in PGL Notes. The dollars involved are so high that even one missed client could cost you thousands of dollars in commission...
>
> With the current high commission ($6.00 per year per $thousand invested), attractive rates, and with the recent publication of our 1985 annual report, the time has never been better to sell PGL Notes.

On April 29, 1987, the marketing and sales division advised sales personnel that a call option was being offered on the one year PGL note only after 30 days of the one-year term. In this plan, a client could cash notes after 30 days with written notice. The full one year commission rate applied on these sales.

3. THE PEOPLE WHO BOUGHT THE NOTES

The schedule of noteholder claims compiled by the Trustee in Bankruptcy for PGL by location as of August 10, 1987, indicates that 157 notes were held by individuals and organizations in British Columbia; it was estimated that the number of individuals having a financial interest in those notes was 2214. The notes held in B.C. comprised approximately 18% of the total number of notes sold and had a value of close to $15.3 million at the time of PGL's collapse.[3]

The lack of sophistication of some of the purchasers of PGL promissory notes is highlighted in the report of Lyman Robinson and in the profile drawn by the Trustee in Bankruptcy for PGL. A preliminary report by the Trustee provided the following description:

> A typical noteholder is older and/or retired and their notes were often purchased with the proceeds of a house sale, a farm sale, sale of a business, an inheritance or life insurance proceeds from the death of a spouse. Many noteholders are also investors in AIC and FIC and some transferred savings from AIC and FIC to Principal Group notes when the savings level exceeded $50,000 or

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[3] Trustee's Preliminary Report to Creditors on the Affairs of Principal Group Ltd. September 24, 1987, Table I.

$100,000. In many cases, the promissory note represents the major asset of the individual and cessation of income from the note has been quite harmful. Despite the term often used to describe them, noteholders, in general, are not sophisticated investors.[4]

The Trustee in Bankruptcy conducted a more extensive survey of PGL noteholders in 1989 and produced the results of a questionnaire. 356 noteholders (in all Provinces) responded to the survey (over 70% of the 496 total). Of the 496 noteholders, 315 were Alberta residents. Twenty-two Hutterite Colonies in Alberta held about one-third of the total dollar value of the notes outstanding. The Trustee estimated that, including the 2,175 people represented by the Hutterite notes, in excess of 11,000 people had a financial interest in the notes. The following data regarding the noteholders are drawn directly from that report.[5]

The survey, conducted in February 1989, indicated that:

1. Of the 344 who responded regarding their occupation, 104 indicated they were retired. Otherwise the occupation represented a broad mix: 27 farmers, 24 housewives, 3 teachers, 3 carpenters, 1 firefighter, 1 musician, 3 millwrights, 2 dentists, 2 nursing aides and 2 truck drivers as examples.

2. Of the 305 who gave their ages, 60.7% were over 60 years of age and 86.2% were over 50 years of age.

3. Significant numbers chose not to answer the questions regarding their annual earnings and approximate net worth. The Trustee's experience has been that many noteholders are reluctant to discuss these matters, in part due to their own embarrassment at being caught in a financial collapse. Of those 176 who did respond regarding annual earnings, 50.6% had annual incomes of less than $15,000. Age was a major factor in the low annual incomes. With regard to the net worth question, 58.1% gave no response and 3.1% gave inappropriate answers. Of the remaining respondents, 8 indicated that they had no assets at all, 19 had assets under $25,000, 16 had assets between $25-$50,000; 58 had assets between $50-$100,000 and 34 had assets over $100,000. This final group included 8 corporations, other groups and organizations, and joint-ownerships.

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[4] Ibid, pp.31-32.

[5] Collins Barrow Ltd., Results from Principal Noteholder Questionnaire, July 31, 1989, pp.2-9.

4. The Trustee made two general conclusions regarding the survey and how the noteholders were affected by the Principal collapse:

   a) In net worth and incomes, there were a wide variety of circumstances. As a result, a few noteholders were relatively unscathed by their losses, but others were severely affected.

   b) Even where noteholders have remaining assets, their lifestyles have often been affected, especially because so many noteholders are senior citizens who now cannot easily reshape their lives.

He also noted that:

> Assessing the level of 'sophistication' was a difficult profile question, since answers would often be subjective. The Trustee's experience was that the noteholders often thought themselves more knowledgeable than turned out to be the case, especially when they explained how they came to make their purchases.

The noteholders, however, viewed themselves as follows:

- six (1.8%) identified their investment knowledge as "very sophisticated"; 177 (52.8%) identified themselves as "somewhat knowledgeable"; the rest, 152 (45.4%), indicated they "...must rely on advice from others".

- when asked if they had a "...good basic understanding of various investment products available in the financial marketplace", 151 (46.4%) said yes and 175 (53.6%) said no.

- when asked: "...are you able to read and understand financial statements and other financial information?", 177 (55.3%) said yes and 143 (44.7%) said no.

Because the minimum investment in PGL was $50,000, prospective noteholders needed a bulk sum to invest. The survey indicated that these bulk sums came from a variety of sources:

- 55 used money that was previously invested in FIC or AIC products;

- 62 used money that was from the sale of their principal residences;

- 33 used money that was from the sale of their farms and

another 35 used money from the sale of their businesses;

- 50 used money from an inheritance (a high percentage of these were widows);

- 183 had money from general savings or earnings; 49 from other investments; and 24 from real estate other than their personal residences;

- many invested money from more than one source (e.g. personal savings and sale of their personal residences).

Significantly, 76% of the noteholders said they purchased because of another's recommendation. The recommendations came primarily from a Principal sales consultant (98.5%) and these recommendations were sometimes supplemented by recommendations from other professional advisers (5.6%), friends or associates (5.9%) and others (8.2%). 246 (69.1%) indicated that they were not aware that the consultants received a commission on sales; 97 (27.2%) were aware and 13 (3.7%) did not reply.

When noteholders were asked how they first came into contact with the Principal consultant who sold them their note:

- 32% said they went into a PS&T office and another 10.1% telephoned a PS&T office;

- over 30% were first approached by the salesperson; 19.3% indicated that they were telephoned at home as the first contact; while 11.6% were first visited at home by a consultant;

- another 8.3% were introduced by a previous PCL consultant while 2.1% were introduced by PS&T employees. Other forms of introduction, mostly referrals by friends or relatives, accounted for 16.3%.

A majority of the respondents (200, representing 57.1%) purchased their notes at a PS&T office. Most others (40.2%) made the purchase from consultants in their own homes, and 2.3% made their purchase by mail.

Ninety-seven of the 200 noteholders who purchased at a PS&T office thought they were buying a guaranteed investment certificate or a term certificate or a deposit. Eleven were seeking an AIC/FIC contract. Another 18 were looking for some form of "safe investment". Ten said they just wanted to invest and were looking for advice or suggestions, 4 sought mutual funds, 3 RRSPs, and 8 did not actually intend to purchase anything. There is no doubt a significant number of noteholders made a different investment than they had originally intended.

The survey also asked the question,

> Did you clearly understand that you had purchased a note from Principal Group Ltd. rather than some other product from one of the subsidiaries (e.g. Associated Investors, First Investors, Principal Savings and Trust)?

Out of 340 respondents, 177 (52.1%) answered yes that they did understand what they had purchased, and 163 (47.9%) said no, they did not. The Trustee noted, however:

> ...even among those who understood that they had purchased a note, other survey answers make it clear that many of these people did not know exactly what a note was. For those who said they did not understand that they had purchased a note, when asked what they thought they had purchased:
>
> - 45 said they were not aware until after the collapse;
> - 97 thought they had a type of term deposit or a GIC;
> - 4 thought they had an AIC/FIC contract;
> - 18 said that their purchase was tied up with all the companies or that the companies were all one.

Representations about the security of the investments in PGL were similar to those made in relation to AIC/FIC, including that there was money on deposit with the Royal Bank equal or greater than their investments (132 noteholders). 92.1% believed that the provincial or federal government was scrutinizing the operations of PGL. 165 respondents indicated that they got this understanding from the consultant they dealt with.

In conjunction with the questionnaires, noteholders were asked to send materials which influenced their decisions to purchase notes. They sent along literature from Principal which left an unavoidable impression that the notes were authorized under the Insurance Act (Alberta), the Trust Companies Act (Alberta) and a long list of other federal and provincial authorities.

Noteholders also sent copies of their applications and receipts for the promissory notes which stated that "Principal Savings and Trust Co. is a member of the Canada Deposit and Insurance Corporation", or similar words (the various forms changed from time to time). These applications and receipts

reinforced the impression many noteholders had of CDIC protection because they made their purchase at Principal Savings and Trust.

The profile of those who bought promissory notes presented by the Trustee in Bankruptcy is consistent with the conclusions of Lyman Robinson based on the interviews he conducted during his Inquiry. Mr. Robinson did not distinguish between the individuals who purchased investment contracts and those who purchased promissory notes. He wrote in his overview:

> Many of the people whose funds are at risk, as a consequence of the failure of First Investors Corporation Ltd., Associated Investors of Canada Ltd., and Principal Group Ltd., are persons who have reached or are approaching normal retirement age. Thirty-four percent of the investors who returned questionnaires to the Commission were over the age of 65 years and this percentage increases to 51% if persons over 60 years of age are included in the analysis. Their funds, which are at risk, are for the most part funds which they had saved for their retirement years. Many of these people had little if any experience with respect to investing money. Indeed, they did not regard themselves as investors but rather as "savers". When they went to "Principal" they were looking for a financial institution where their retirement savings would be kept safely and bear interest at a competitive rate.[6]

Of the purchasers of promissory notes in British Columbia who complained to our office directly, the following comments are representative of that segment of the investors who were relatively unsophisticated:

> We were unfortunate victims of the bait and switch routine. We went in to the Principal Trust office to get a G.I.C., covered by C.D.I.C., paying interest monthly, to give my 88 year old mother a monthly income. We were told that they did not have G.I.C.'s paying monthly, but they had this other plan, equally as safe, that we could use. We ended up with a promissory note.
>
> We feel we have been treated very unfair as we thought when we invested in any of the Principal Companies it was all one entity.
>
> He (the salesman) did not recommend a "promissory " note, he recommended a "corporate note". Since I had my term deposit with P.S.and T. and which I purchased from him,

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[6]Robinson, Ibid, p.9.

I naturally felt "corporate" meant P.S.and T. I didn't know the other companies existed and there was certainly no indication of their existence in the office.

On June 13, 1987, I invested $50,000 with "Principal Group". I was told by the salesman that my investment was going into Government Bonds, and was assured there was absolutely no risk. I am a widow, and I used my husbands insurance money for this No Risk Investment.

...I had advised him to deposit my savings of $100,000 in two separate accounts, $50,000 in my name and $50,000 in my wife's name, and these monies were to be insured by the Canada Deposit Insurance Corporation in the amount of $60,000 on both accounts. Mr. ------ instead put our savings into a Principal Group "Guaranteed" Certificate which was not insured by the Deposit Corporation and I don't know how much of these monies I will receive and when. It has taken me thirty years to save this money and my wife is a quadriplegic and I am disabled and unable to work...

This note was purchased in September 1986 and was to mature in September 1987. The funds were from my many years of savings towards my retirement and I could ill afford the loss. I had dealt with the Principal Group for several years, however did not realize that the Canada Deposit Insurance Corporation did not protect my investment. The only assurance I got from the consultant was that the note was backed by the Principal Group of Companies...

II. AN OVERVIEW OF SECURITIES REGULATION

1. WHY SECURITIES ARE REGULATED

The traditional goal of securities regulation has been the protection of the investor. That statement has an appeal which is misleading in its simplicity. It focuses on only one of a number of parties to a securities transaction. Moreover, it fails to reflect the fact that the goal of protection must be achieved while taking into account the diverse range of other objectives, some of which compete with one another.

We may begin by observing that the political system which erects laws for the protection of the investor operates on the basis of a number of implicit assumptions. These may not receive the same public emphasis as investor protection but nonetheless must be taken as a `given' by any regulatory framework. Two current examples in Canada are: first, investor protection is to be achieved without an excessively heavy burden of cost or rigidity; secondly, an element of risk for private capital, with an attendant chance of loss or failure, is an inherent feature of our national economy to which both investors and business enterprises must consider themselves subject.

Besides the goal of protection, with its somewhat negative tendency to repress and restrict, the regulatory thrust is expressed positively in the attempt to ensure that Canadian capital markets operate efficiently and fairly and command a full measure of public confidence.[1]

As Johnston notes, securities regulation is a complex matter involving the weighing and attempted balancing of many sometimes competing interests. To regulate every financial transaction would not only be prohibitively expensive and time-consuming but it would also collapse the financial marketplace: capital would leave for other jurisdictions with less restrictive regulations. To regulate no financial transactions would lead to the same result though by a different route: investors offered no protection would not invest so that companies needing those dollars would move elsewhere.

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[1] D.L. Johnston, Canadian Securities Regulation (Toronto: Butterworth, 1977), pg.1.

It is the elected legislator who is charged with the responsibility of steering the course between these two extremes. In fashioning a particular securities law, the legislator will be guided by several factors. He or she will wish to provide as much safety as possible for an investor and yet, being answerable to the people, will not wish to overburden the taxpayer either by regulating unnecessarily or by charging to the taxpayer a cost more properly borne by the investor.

And while wishing to protect the individual investor, the legislator must also recognize that British Columbia is but one of the many jurisdictions world-wide that compete to attract capital for economic development. Because of this, any regulatory scheme that is set up must not stray too far from international norms or it will fail to attract capital.

Inevitably, it is the legislator who must decide how to strike the balance between security for the investor and opportunity for capital. This balance finds its expression in statutory law.

While it is the legislators who define the law and enact the statutes, it is the administrators or regulators who are charged with the responsibility of carrying out the provisions of these statutes. Their authority proceeds from the statute; they themselves have no mandate either to create duties for themselves or to exceed or limit the powers granted to them under the statutes they administer.

In this chapter we provide an overview of securities regulation. We begin by examining the history of securities regulation because this graphically demonstrates how, over the course of many centuries, various governments have tried to attain that balance. We also examine the methods by which securities are regulated and focus on the cornerstone concept of disclosure and the exemptions from it.

The importance of taking this historical approach cannot be underestimated. One cannot examine the situation involving PGL noteholders without a context, for they and their investments are part of an interaction of complex issues and it is only through an appreciation of these interrelated issues that one can hope to understand what happened and seek

to provide measures that might in future help to prevent such losses.

2. A BRIEF HISTORY OF SECURITIES REGULATION

A. 1285-1843

> The pernicious art of Stock-jobbing hath, of late, so wholly perverted the End and Design of Companies and Corporations erected for the introducing, or carrying on, of Manufacturers, to the Private Profit of the first Projectors, that the Privileges granted to them have commonly, been made no other use of, by the First Procurers and Subscribers, but to sell again, with Advantage, to ignorant Men, drawn in by the Reputation, falsely raised and artfully spread, concerning the thriving State of their Stock.[2]

Prior to the introduction in England in 1844 of the Joint Stock Companies Act there was no organized attempt to regulate either companies or the securities they marketed. Rather, there were haphazard reactions to particular events beginning in 1285 with the requirement that all brokers within the City of London be licensed. However, in terms of a law of national scope, nothing came on the books until 1697 at which point a law requiring that salesmen be registered came into force, largely as a result of the report of the Special Commission quoted above. Even here, though, the statute lapsed after 10 years and was not renewed.

As a maritime nation, England became increasingly engaged in international trade, and the capital required to support such foreign adventures led to the development of what were then known as "Joint-Stock" companies. These were companies where the shareholders pooled their capital in order to pursue a common purpose.

By the beginning of the 18th century there were really only three significant joint-stock companies: The Royal African, the East India, and the Hudson's Bay Companies. However, within a decade great commercial speculation in the South Seas was aroused and more than of 200 joint stock companies were formed. Stock speculators, free to trade without restriction, "hyped" their stocks unreservedly. When the economic basis for this excitement proved false, the companies collapsed and with their collapse came the loss of the shareholders'

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[2]Report of a Special Commission to the House of Commons in 1696 cited in Johnston, Ibid, pg.9.

investments.

The response to these collapses was the Bubble Act of 1720 which essentially outlawed the sort of company where shares could flow around without control. The only alternative to joint-stock companies was a special act of incorporation passed in Parliament, a method which was expensive, time-consuming and not widely available.

After the Bubble Act, trading activities quietened down for a period, but following the Napoleonic Wars enthusiasm was galvanized and Britain of the 1820's was once again rife with speculators and promoters. Between 1825 and 1826 alone over 600 new companies emerged of which only 100 survived the year.

Once again, the English legislators were confronted with economic instability. However, the old random approach to securities regulation was soon to end as Parliament decided on a more focused approach.

B. 1844-1910

> Publicity is all that is necessary. Show up the roguery and it is harmless.[3]

This, in a nutshell, was William Ewart Gladstone's approach to investor protection when he was president of London's Board of Trade in the 1840's. Responding to a report he prepared, Parliament passed England's first company act in 1844: The Joint Stock Companies Act. Codifying Gladstone's belief that disclosure was the key to safe investment the statute imposed several requirements upon companies. The Act required that a copy of any prospectus used in a sale had to be filed in a central registry, annual statements had to be made available for inspection by shareholders, and all trading in shares had to be revealed.

The reaction to the statute by the corporate community highlighted the delicate balance that a legislator must maintain between the interests of companies, which, after all, fuelled economic development, and those of investors. The two decades following the passing of this statute showed considerable backtracking as the objections from the financial community mounted. In 1847 the requirement of filing prospectuses was dropped as it was found to create too heavy a burden on promoters; in 1855 limited liability was granted to companies; and in 1856 Parliament abolished all reporting

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[3]Cited in "Disclosure Requirements", Proposals for a Securities Market Law for Canada, (Vol.3: Background Papers) W.M.H. Grover and J.C. Baillie at pg.364, footnote 43.

requirements.

Thus freed from the burden of reporting duties, promoters and speculating began to flourish. Inevitably, the market boomed, crashed, and Parliament struck another committee, which, in 1867, led to the introduction of a new Companies Act. The new Act spelled out when a prospectus was required, the need for investors to be presented with one, and attached civil liability to the failure to do so. However, the prospectus did not have to be filed with government regulators which meant that they would not necessarily know what was being said in any given prospectus.

Obviously Parliament had attempted to strike a balance by providing limited liability as a protection for promoters and a prospectus as a protection for investors. That safety for investors was, of course, dependent on the accuracy of the information disclosed in the prospectus. This "safety" was tested in 1889 when the House of Lords brought down its decision in Derry v. Peek 14 A.C., 337. In that case, a director of a company was charged with having issued false statements in a prospectus. The House of Lords found that if a director believed statements to be true then that was a defence even if it was not reasonable for him to believe such statements.

Not surprisingly, Parliament countered with the Directors Liability Act in 1890 which made the test of directors' liability not "belief" but "reasonable belief".

A further Committee of the Board of Trade grappled with the notion of whether government should actually examine a prospectus to see if the proposed business plan was sound. In their Report of 1895 members stated their conclusion:

> Your Committee may observe that they have dismissed from their consideration every suggestion for a public inquiry by the registrar or other official authority, into the soundness, good faith, and prospects of the undertaking at this or any other stage of a company's formation. To make any such investigation into the position of every new company complete or effectual would demand a very numerous staff of trained officers, and lead to great delay and expense, while an incomplete or perfunctory investigation would be worse than none. It would be an attempt to throw what ought to be the responsibility of the individual on the shoulders of the State, and would give a fictitious and unreal sense of security to the

investor, and might also lead to grave abuses.[4]

As a result, disclosure continued to be the watchword. A new Companies Act in 1900 further defined "prospectus". Nevertheless, a company did not need to issue a prospectus so long as it did not advertise.

If we shift the focus to Canada during this period, we note that Canada, not unexpectedly, followed England's lead. British Columbia passed its first Companies Act in 1897, modelled directly on its English counterpart. Ontario, in 1907, took the English prospectus requirements and made them of much more general application than had the English.

Summing up the period from 1844-1910, we can say that it witnessed the introduction of statutes regulating companies. The focus was not on "traders" in securities but on the companies who issued the securities. The chief investor protection device was "disclosure" - the belief being that if advised of the risks, an investor could make an appropriate investment decision.

C. 1911-1944

> ...if said Bank Commissioner finds that such articles of incorporation or association, charter, constitution and bylaws, plan of business or proposed contract, contain any provision that is unfair, unjust, inequitable or oppressive to any class of contributors, or if he decides from his examination of its affairs that said investment company is not solvent and does not intend to do a fair and honest business, and in his judgment does not promise a fair return on the stocks, bonds or other securities by it offered for sale, then he shall notify such investment company in writing of his findings, and it shall be unlawful for such a company to do any further business in this state...[5]

The State of Kansas in 1911 became the first common law jurisdiction to turn the regulatory focus from "disclosure" of information to "licensing". The statute provided for the registration of issuers, salesmen and the securities they sold. A duty was imposed upon issuers to register with the

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[4]Cited in J.P. Williamson, Securities Regulation in Canada (Toronto: University of Toronto Press, 1961), at pp.6-7, footnote 7.

[5]Williamson, Ibid, at p.11, footnote 17.

Kansas Bank Commissioner. In turn, the Commissioner would examine and evaluate the company seeking registration and if it was not deemed suitable it would not be permitted to carry on business.

The Kansas legislation came about because promoters from the eastern states had been perpetrating frauds on Kansas farmers for several years. This legislation, and other laws that followed its lead, became known as "Blue Sky Laws". It has been suggested that this term was coined in 1916 in an article in the Canadian Law Times where promoters were described as people who would:

> ...sell building lots in the blue sky in fee simple. Metonymically they became known as Blue Sky merchants, and the legislation to prevent their frauds was called Blue Sky Laws.[8]

The appeal of the Kansas approach was also felt in Canada. Within a year Manitoba had passed a similar Sale of Shares Act followed by Saskatchewan in 1914, Alberta in 1916, New Brunswick in 1923, and Quebec in 1924. In 1928 Ontario passed the Ontario Security Frauds Prevention Act which was a comprehensive statute requiring the registration of brokers and salesmen and containing a strict definition of fraud. The singular focus on disclosure of the 19th century statutes had broadened by the early 20th century to one focusing on the sellers of securities as well.

Eventually in 1933 the U.S. Securities Act came into existence. Rather than follow any of the various state "Blue Sky" models it favoured a modified Gladstonian disclosure system. Under the 1933 Act a company had to file a prospectus with the Securities and Exchange Commission (just as a company had to file under the 1844 English Joint-Stock Companies Act), but, (unlike the old English Act) the company could not sell for 20 days after filing and during that period the Securities and Exchange Commission would check the prospectus for any misstatements or omissions. In 1934, the Securities Exchange Act came into being as a parallel statute that required the registration of brokers and mandated periodic updates of information (continuous disclosure).

Still, no securities acts had come into existence in England or in Canada, although with the tandem U.S. federal acts a new model had come forward.

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[8] Cited in J.L. Mericle, "U.S. Securities Law" C.L.E. Securities Law (Vancouver, 1989), at pg.6.1.17.

D. 1945-1987

> We are not so optimistic as to believe that any legislation, however wisely conceived and effectively administered, will prevent all foolish investments or all unsound company promotion. We have, indeed, no right even if we had the desire, to take away from the citizen his inalienable right to make a fool of himself. We do, however, feel that we have the right to attempt to prevent others making a fool of the citizen. We would emphasize also, first, that permission for a group of persons to be incorporated into a company should be viewed as a valuable concession granted by the state, especially in relation to the convenience of a general restriction of personal liability, and, second, that such a concession involves corresponding obligations and responsibilities. Not the least of these obligations is to ensure that there shall be full and accurate information as to all the facts concerning every company that seeks incorporation or financial support from the public after such incorporation.[7]

The preceding quote comes from the report of the Royal Commission on Price Spreads in 1935. It highlights, once again, the view that the responsibility for making investments rests with individual investors although, as a counterbalancing obligation, companies must ensure that an investor has "...full and accurate information as to all the facts".

Though the federal government did not, and still has not, introduced a securities act, Ontario did so in 1945. Once again the impetus was a rash of fraudulent stock promotions which this time had not only raised the ire of Ontarians but also of Americans. The report of the Royal Commission on Mining, 1944 concluded that the statutory framework of the day was defective in that not only did it unduly impede prospecting activity but it also failed to curb fraud.

The 1945 Ontario Act has been referred to as the first modern Securities Act in Canada and it became the model for securities legislation in Canada until 1967 when Ontario brought in a new act.

The essential theme of the 1945 Act was that there be full disclosure and that it reach the would-be purchaser. At the same time, from a policy viewpoint, it was made clear that the Securities Commission would not be passing judgment on the

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[7]Cited in Grover and Baillie, Ibid, at pp.371-372.

soundness of the proposed business venture itself; that responsibility was the investors'.

Essentially, the Act forbade any trading in the security until a "statement" had been filed with the Commission and a "receipt" issued for it. Further, a copy of this statement had to be given to each prospective investor. The scrutiny directed at these statements went beyond simply looking for misstatements and omissions; a certain level of attention was directed at possible "unconscionable considerations" and also at some basic financial soundness tests, but, as noted, the scrutiny did not extend to passing judgment on the soundness of the proposed venture itself.

During the early 1960's a series of important reports concerning the financial marketplace emerged as the result of insider trading problems and financial failures. These resulted in the Ontario Securities Act of 1966 which came into effect in May of 1967. British Columbia, which had introduced its first Securities Act in 1962[8], revamped it in 1967 to reflect the changes made in the Ontario statute.

It was the Securities Act of 1967 in B.C. which held sway for 20 years until on February 1, 1987, the Securities Act S.B.C. 1985 was proclaimed. We will leave consideration of that statute until we deal first with methods of regulating the securities market.

3. METHODS OF REGULATING THE SECURITIES MARKET

The foregoing historical description highlights the complexities of securities regulation and demonstrates the patchwork approach taken over the years. It also underlines the fact that an economic transaction does not take place in a vacuum; many interrelated and often competing factors must be taken into account. The philosophic and political direction of the legislators in various governments also affected the balancing.

Modern securities acts weave together three approaches to securities regulation. It is generally recognized that elements of all three are necessary if one is to have a

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[8]British Columbia enacted the Security Frauds Prevention Act in 1930. As its title implied, the statute was directed less to the regulation of securities than to the prevention of frauds. In 1933 this statute was retitled the Securities Act and introduced the Office of Superintendent of Brokers. However, the basic statutory scheme remained unchanged until the Securities Act, 1962, which came into force July 1 of that year.

comprehensive approach to regulation. The three approaches are: anti-fraud measures, registration of persons and institutions, and registration of securities.

Anti-fraud measures define fraudulent conduct, provide penalties for those engaging in such conduct and create investigatory and enforcement tools to help identify and suppress the fraudulent conduct. These measures are designed to protect investors; however, because the measures are generally not remedial, the protection is indirect, in that their very existence is expected to deter fraudulent behaviour.

The requirement that persons selling securities be registered is also aimed at investor protection, though by a different route. The general idea is that a person who might be entrusted with another's money should be honest, competent and knowledgeable. The registration of institutions comes from similar concerns with respect to the directors and officers of a corporation and also extends to the financial stability of these corporations.

The registration of securities themselves is a far more complex area. It is important to know that this regulatory technique operates on a continuum. There are, as we shall see, securities for the sale of which a statute exempts the need to disclose any information to a purchaser or even to notify the Superintendent of Brokers. Further, there are securities for which an issuer need do no more than notify the regulatory agency of a completed sale. Further along the continuum there is disclosure, generally in the form of a prospectus, where a regulatory agency, prior to permitting trading in the securities, examines the offering put forward by the institution to assure itself that the written description of it is full, frank and truthful so that an investor has sufficient reliable information with which to evaluate the risks. At the extreme end of the continuum, in some jurisdictions a regulator must be satisfied that not only are the risks in the offering presented fully but also the venture is financially viable.

But regardless of the fact that all securities acts intertwine these three approaches to securities regulation, it is disclosure which is the cornerstone for modern securities regulation in Canada. It is essentially a development on the theme elaborated by Gladstone a century and a half ago. From an analytical viewpoint it proceeds on the basis that a security purchase crystallizes at the moment when an investor decides that a particular investment involves a risk he or she is willing to take. The evaluation of that risk becomes possible only if the investor has sufficient information about the investment.

It is worth noting that in the case of the PGL noteholders a great many of them did not purchase the investment they believed they were purchasing. Accordingly, they were unaware of the risk involved. Had the nature and risk of their investment been disclosed to them it is reasonable to conclude that a great many of them would not have proceeded with the purchase.

4. DISCLOSURE

Disclosure has as one of its chief aims the removal of any imbalance of pertinent information existing between buyer and seller. The seller, generally, is in possession of facts regarding the value of the investment, and the risk involved in the investment being sold. The buyer, without disclosure, is not in possession of those facts and consequently is dependent upon representations made by the seller unless, of course, he or she has other means of evaluating the investment. Disclosure narrows the gap between the two.

Against the view that disclosure is necessary in order to provide protection for investors lies a counter-balancing view which places a value on the privacy of some information. For instance, complete disclosure could mean that trade secrets or patents would be unprotected.

Another frequently noted argument against disclosure is that it costs money. The greater the disclosure the greater the cost. And ultimately it is the public who will pay for the cost of this disclosure. While some of this "public" cost will be borne by the purchaser of securities much will be borne by the general public - the majority of whom probably derive little benefit from it.

But for all that has been said about disclosure being the cornerstone of securities legislation, when one considers the vast array of financial transactions which take place daily one begins to appreciate that if they all were subject to disclosure the system would quickly come to a halt.

As the result of this, it is recognized in the securities field that there are certain "trades" which take place in securities where the protection afforded by disclosure is deemed not to be necessary. These trades are known as "exempt trades".

5. EXEMPTIONS

Automatic exemptions from requirements of the Securities Act are based upon either the nature of the trade or the nature of the security being traded. In any given trade there may be an exemption from either or both of the registration and

prospectus requirements generally found in securities acts.

As well, it is possible to obtain a discretionary exemption from the registration and prospectus provisions of the Act by applying to the Superintendent or the Securities Commission with respect to particular trades. Prior to the Securities Act, S.B.C. 1985 coming into force on February 1, 1987, a great number of these "discretionary" exemption applications were made to the B.C. Superintendent of Brokers. It was partly as a result of the tremendous workload that this created that the 1985 Act made many of these "automatic".

The rationale for all exemptions proceeds on the assumption that some trades involve securities with little risk attached to them (such as Canada Savings Bonds) and some trades involve purchasers who do not require the information afforded by a prospectus (such as a lending institution). Consequently, it is thought, to impose the registration and prospectus provisions of the Act would unnecessarily impede the flow of investment capital while at the same time serve no useful purpose.

The whole field of exemptions is complex and thoroughly detailed in the B.C. Securities Act, S.B.C. 1985 and its regulations. It need not be fully examined here as we are concerned in this report with the sales of promissory notes by PGL and the exemptions under which those notes were sold. In the next chapter we will deal with the British Columbia Securities Act, R.S.B.C. 1979 and the British Columbia Securities Act, S.B.C. 1985, with particular reference to those sections relevant to the sale of promissory notes by PGL.

III. THE B.C. SECURITIES ACT AND THE SALE OF PGL NOTES

1. THE GENERAL SCHEME OF THE SECURITIES ACT

> Just as there is no policeman at every traffic signal, with the result that persons are injured from time to time, often grievously, so there is no regulator to oversee every economic transaction, and persons are injured from time to time, often grievously. The existence of securities regulation and securities regulators is no more an assurance that all economic transactions will be acceptable or socially desirable than, for example, the presence of academics ensuring the education of students.[1]

As noted previously, British Columbia introduced its first Securities Act in 1962. This Act was substantially upgraded in 1967 and modelled after the Ontario statute of the preceding year. The '67 Act remained essentially unchanged until the introduction of the Securities Act, S.B.C. 1985, which came into effect February 1, 1987. The statutes of British Columbia were consolidated in 1979 with the consequence that the Securities Act of 1967, although essentially unchanged, was subsequently referred to as the 1979 Act. In this section, our comments on the Securities Act will refer to the 1985 Act unless otherwise noted.

In British Columbia, the general rule is that no security may be traded unless the person effecting the trade is registered to trade in securities. The Act and its Regulation do, however, contain a number of exemptions whereby trades in specified securities or by specified persons may be effected without complying with the registration requirement. In addition, application can be made to the Securities Commission or Superintendent for an order or determination exempting specified persons, securities or trades from the registration requirement of the legislation.

The registration requirement of the legislation is intended to ensure that the investing public obtains the benefit of advice from a registered salesperson who has met the minimum educational and ethical standards imposed by the Commission or Superintendent through the registration process. Exemptions

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[1] H.J. Knowles, "Comment on Reregulating the Regulator" in Securities Law Special Lectures (Toronto: Law Society of Upper Canada, 1989) at pg.125.

from the registration requirement permit trading in securities by unregistered persons where the investor is not believed to require the protection offered by having a registered salesperson involved in the trade.

Section 20(1) of the Act sets out the registration requirement:

> 20. (1) No person shall
>
> (a) trade in a security unless he is registered as
>
> (i) a dealer, or
> (ii) a salesman, partner, director or officer of a registered dealer and is acting on behalf of that dealer,
>
> (b) act as an underwriter unless he is registered as an underwriter, or
>
> (c) act as an adviser unless he is registered as
>
> (i) an adviser, or
> (ii) a partner, director or officer of a registered adviser and is acting on behalf of that adviser in accordance with the regulations.

As s.20 states that "No person shall trade in a security...", it is necessary to examine the definition of "trade" and "security".

Section 1(1)(a) of the Act defines "trade" as including:

> (a) a disposition of a security for valuable consideration whether the terms of payment be on margin, instalment or otherwise, but does not include a purchase of a security or a transfer, pledge, mortgage or other encumbrance of a security for the purpose of giving collateral for a debt...

This definition would include the sale of promissory notes to the PGL noteholders.

Section 1(1)(d) of the Act defines "security" as including:

> (d) a bond, debenture, note or other evidence of indebtedness, share, stock, unit, unit certificate, participation certificate, certificate of share or interest, preorganization certificate or subscription other than

(i) a contract of insurance issued by an insurer, and
(ii) an evidence of deposit issued by a savings institution...

This definition would include the promissory notes sold to the PGL noteholders.

As mentioned, these registration requirements are intended to ensure that those trading in securities meet minimum educational qualifications and minimum ethical standards.

As a second general rule, all distributions of securities by issuers must be qualified by filing a prospectus with the Commission or Superintendent and obtaining a receipt for it. The prospectus sets out full, true and plain disclosure with respect to the issuer and the securities being offered for sale and is intended to permit the investor to make a reasoned investment decision. The Act and its Regulation contain a number of exemptions from the prospectus requirement which permit issuers to distribute securities without filing a prospectus. In addition, application can be made to the Commission or Superintendent for an order or determination that the prospectus requirement does not apply to certain trades.

Section 42(1) of the Act sets out the prospectus requirements:

42. (1) Unless exempted under this Act or the regulations, a person shall not distribute a security unless a preliminary prospectus and a prospectus respecting that security

(a) have been filed with, and
(b) receipts obtained for them from, the superintendent

As s.42 of the Act states that "...a person shall not distribute a security unless...", it is necessary to examine the definition of "distribution".

S.1(1) of the Act states:

"distribution", means, when used in relation to trading in securities,

(a) a trade in a security of an issuer that has not been previously issued...

This definition would include the sale of promissory notes to the PGL noteholders.

In summary, the general scheme of the Act stipulates that a trade in securities requires that those doing the trading be registered pursuant to section 20 of the Act. In addition, the security traded requires qualification under section 42 of the Act by way of a prospectus. In this way it is thought that only a person suitably qualified through registration would sell a security and only a person with the knowledge provided through a prospectus would buy it.

That having been said, the Act also recognizes that there are trades that occur frequently in the marketplace where such regulatory protection is not thought to be needed. Consequently, the legislation provides for various exemptions from either or both of the registration and prospectus requirements. These exemptions are detailed in the Act and the Regulation and as noted previously are based on either the nature of the security or the nature of the transaction.

As PGL sold all of its promissory notes pursuant to statutory exemptions we will examine those exemptions.

2. THE SHORT-TERM NOTE EXEMPTION

PGL kept a "log" of the promissory notes it sold in British Columbia. According to this log, the first note was sold on November 3, 1981 and the last one on June 27, 1987.[2] During this period 792 notes were sold in the amount of $78,426,095.

PGL sold its promissory notes pursuant to exemptions available under the Securities Act R.S.B.C., 1979 and the Securities

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[2]This "log" compiled by PGL, differs from the "list" of B.C. noteholders whose notes were outstanding at the date of bankruptcy compiled by the Trustee in bankruptcy for PGL. We have chosen to use the "log" rather than the "list" in order to highlight the continuous volume of sales by PGL in B.C., particularly of the short-term notes. By definition, any short-term note purchased prior to August 9, 1986 would have been paid out or rolled-over before the bankruptcy of August 10, 1987. If one relied only on the "list", one might mistakenly conclude that PGL did not sell many short-term notes prior to the summer of 1986. As the "log" indicates, it sold millions of dollars in short-term notes prior to the summer of 1986, and in fact it was this market, and not the longer term note market, where it raised almost all of its capital.

It should also be pointed out, that while the "log" ends at June 27, 1987, PGL did sell promissory notes in B.C. until June 30, 1987. [The "log" also shows a sale on July 10, 1987, but this was cancelled].

Act, S.B.C. 1985 (which came into effect February 1, 1987). As the statutes had different requirements we will examine the sale of short-term notes under the different Acts separately.

A. THE SECURITIES ACT R.S.B.C. 1979

Prior to marketing its notes in B.C., PGL had secured a legal opinion from an Edmonton law firm which in turn had consulted with extra-provincial law firms in order to give its May 1, 1981 opinion. With respect to the sale of notes in B.C., the opinion stated:

> No registration is necessary and no prospectus need be filed in order that the company may offer the Notes[3] maturing not more than one year from the date of issue for sale to the public in the provinces of Alberta, British Columbia, Saskatchewan, Ontario, New Brunswick, Nova Scotia, Newfoundland and Prince Edward Island, provided that...
>
> (b) in the case of an offer in the provinces of British Columbia, Alberta and Ontario, no sale may be made to an individual of a Note having a denomination or principal amount less than $50,000...

The exemption from the registration requirements referred to was found in section 20(2) of the Securities Act:

> (2) subject to the regulations, registration is not required to trade in...
>
> (d) negotiable promissory notes or commercial paper maturing not more than one year from the date of issue, provided that a note or commercial paper traded to an individual has denomination or principal amount of not less than $50,000...

The exemption from the prospectus requirements (s.36) was found in section 54(2) of the Securities Act:

> (2) Section 36 does not apply to securities...
> (a) that are referred to in section 20(2)...

The exemption just mentioned is referred to by various names; we will refer to it here as the "short-term note" exemption. Alboini in his text on securities law gives the following explanation for the exemption:

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[3]The legal opinion defined Notes as "...unsecured negotiable promissory notes".

> [Section 20(2)] is designed primarily to provide an exemption from the dealer registration requirement for large commercial corporations which raise capital from the public by issuing short-term promissory notes or what is commonly referred to as commercial paper. These securities, along with federal treasury bills and other debt securities with a term exceeding one year but usually with a maturity of less than three years, comprise the money market for corporations, financial institutions and governments in need of cash on a short-term basis, issue commercial paper and others with surplus cash available for a short period of time invest in money market securities. The exemption is granted on the basis that investors in commercial paper are not thought to be in need of the protection that participation by a registrant (or prospectus disclosure) would provide. Investors in money market securities are generally sufficiently sophisticated and influential that they can fend for themselves and either are in possession of sufficient knowledge or in a position to acquire it by virtue of their relationship with the issuer.[4]

Private placements - a term referring to securities sold on the exempt market and including commercial paper sales - have an enormous effect in the money market. A 1984 study estimated that approximately 25 billion dollars or about 44% of the 56 billion dollars raised by corporations in Canada during the period from 1976 to 1982 was generated by private placement financing.[5]

Between November 3, 1981 and January 31, 1987, while the Securities Act, R.S.B.C. 1979 was in effect, PGL sold 656 notes having a value of $65,254,353. Of this number 649 notes having a value of $64,046,592 (98.15%) were sold pursuant to the exemption in section 20(2). The other seven notes, having a value of $1,207,761, did not qualify for this exemption because they matured beyond the stated one year period. Accordingly, they were marketed pursuant to a different exemption which is discussed below.

Because PGL sold the great majority of its promissory notes pursuant to the short-term note exemption, we will examine this exemption in some detail.

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[4]V. Alboini, Ontario Securities Law (Toronto: De Boo, 1980), at pg. 276.

[5]Cited in D.W. Drinkwater, W.K. Orr, and R. Sorell, Private Placements in Canada (Toronto: Carswell, 1985), at pp.1-2.

The first reference in Canada to a commercial paper exemption is to be found in the Security Frauds Prevention Act, R.S.O. 1928, chapter 34, section 3(3)(j).

> (3) Subsections 1 and 2 shall not apply to any person in respect of any of the following classes of trades or securities...
>
> - (j) Negotiable promissory notes or commercial paper maturing not more than a year from the date of issue.

This provision was duplicated in Alberta by the Security Frauds Prevention Act R.S.A. 1929, chapter 10, section 3(3)(j). It entered British Columbia law as part of this province's first statute dealing with securities in 1930. Section 3 of the Security Frauds Prevention Act 1930, chapter 64 stated:

> Part I of this Act shall not apply with respect to trades in securities of the classes following:...
>
> - (k) negotiable promissory notes or commercial paper maturing not more than a year from the date of issue...

It will be noted from the preceding definitions that there were no limitations placed upon who could purchase promissory notes as long as the maturity date of the notes did not extend beyond one year from the date of issue.

A useful explanation for this type of exemption can be found in the debates in the Senate and House of Representatives in the United States. In 1933, just prior to the U.S. passing its first federal Securities Act, the Senate had proposed to deal with short-term notes, not by providing exemptions for them within a Securities Act, but by stating that they were not a security to begin with.[6] The Senate Bill proposed to exclude notes, drafts etc.:

> ...which are commercial paper and arise out of current commercial, agricultural, industrial etc. transactions...when such paper is not offered or intended

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[6] Williamson, Ibid, who wrote Canada's first text on Securities Regulation, stated: "Short-term negotiable instruments are not properly within the purview of the Securities Act" (pg.132).

to be offered for sale to the public.[7]

The House of Representatives, however, did not exclude short-term notes from the definition of a security but rather included them and then provided an exemption for them. The House Bill did refer to these kinds of commercial paper as being "...rarely bought by public investors".

What is clear is that in the minds of the drafters in both the Senate and the House the exemption they were providing was not for the sort of security generally bought by the public. The Securities Act 1933, provides the commercial paper exemption in section 3(3):

EXEMPTED SECURITIES

Sec.3.(a) Except as hereinafter expressly provided the provisions of this title shall not apply to any of the following classes of securities:...

(3) Any note, draft, bill of exchange, or banker's acceptance which arises out of the current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited...

As Bloomenthal notes:

> There is a well-developed market in the United States for short-term commercial paper designed to finance short-term credit needs of large corporations. Principal purchasers of this paper are the large corporations and institutional investors looking for short-term parking of their excess cash at interest rates above what they can expect to receive from the purchase of treasury bills and time deposits.[8]

The Securities and Exchange Commission, which operates federally in the United States much as our provincial

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[7]Curiously, the latter clause "not offered...for sale to the public" was later deleted by an amendment on the floor after some heated discussion. Cited in H.S. Bloomenthal, Securities Law Handbook (New York: Clark, Boardman, 1990-91), at pg.69.

[8]Bloomenthal, Ibid, at pg.65.

securities commissions do in Canada, issued an interpretation bulletin with respect to this section on September 20, 1961 in order to make clear what it understood the purpose of this exemption to be:

> The legislative history of the Act makes clear that Section 3(a)(3) applies only to (1) prime quality negotiable commercial paper, (2) of a type not ordinarily purchased by the general public, that is, (3) paper issued to facilitate well-recognized types of current operational business requirements and (4) of a type eligible for discounting by Federal Reserve banks.

The commercial paper exemption received little attention in Canada until the early 1960's. During this period there arose a concern, particularly in Ontario, about finance companies raising capital by using this exemption to sell short-term promissory notes to individuals. These finance companies became known as the "Ten percenters" on the basis that they frequently offered ten percent interest on short-term notes, a rate considerably in excess of the interest rate otherwise offered at the time.

A major seller to individuals was the Prudential Finance Corporation Ltd. The company, founded in 1928, was by 1961 coming under pressure from its bankers. The controlling interest was sold to its principal shareholder, who shortly thereafter began to issue short-term notes to the public. Gross income (before provision for interest, expenses, and bad debt) rose from approximately $100,000 in 1961 to about $1,500,000 in 1963. The financial statements issued by the company in a prospectus accepted for filing by the Ontario Securities Commission on June 20, 1963, indicated that the company had a liability of approximately $8,000,000 to over 8,000 noteholders.

The Ontario Securities Commission acted quickly to curtail the use of this exemption to raise money from individual members of the public by amending the Securities Act effective July 1, 1963. In An Act To Amend The Securities Act 1963, chapter 131, section 10 amended the commercial paper exemption so that it exempted:

> Negotiable promissory notes or commercial paper maturing not more than one year from the date of issue provided that each such note or commercial paper traded to an individual has a denomination or principal amount of not less than $50,000.

It was believed that by legislating such a high minimum figure

($50,000), where the purchaser was an individual only "sophisticated" investors would be attracted.

British Columbia followed this example in An Act To Amend The Securities Act 1963, chapter 39. However, as opposed to Ontario, it disallowed the sale of commercial paper to individuals entirely. What was then section 21(d) of the Securities Act was re-written to exempt:

> Negotiable promissory notes or commercial paper maturing not more than a year from the date of issue and not offered for sale to an individual.

In 1964, Alberta amended its provision in An Act to Amend the Securities Act 1955, 1964, chapter 83. In its exemption it followed B.C.'s lead rather than Ontario's.

However, when Alberta brought in its new Securities Act three years later - the Securities Act 1967, chapter 76 - it revised the commercial paper exemption once again to align it, this time, with Ontario.

Not long after, in the Statute Law Amendment Act, 1971, chapter 58, B.C. joined with Ontario and Alberta by amending section 21(2)(g) to read:

> Negotiable promissory notes or commercial paper maturing not more than one year from the date of issue, provided that a Note or commercial paper traded to an individual has a denomination or principal amount of not less than $50,000.

This exemption has remained virtually unchanged in Ontario, Alberta and B.C. since that date. Some Canadian provinces, while providing a general commercial paper exemption, do not allow the sale to an individual regardless of a minimum dollar value.

As noted, the rationale for providing the exemption to individuals, so long as the short-term note has a minimum value of $50,000, was that somebody with that amount of money to invest for a short period must be taken to be sufficiently sophisticated in money market matters as to not need the protection provided by the registration and disclosure requirements.

This somewhat long preamble is intended to highlight the nature and purpose of the commercial paper exemption.

In returning to section 20(2) of the Securities Act, R.S.B.C. 1979, it will be noted that there were three preconditions to the availability of this exemption for PGL:

1. The promissory notes had to be negotiable;

2. The notes could not mature more than one year from the date of issue; and

3. If they were being sold to an individual they had to have a denomination or principal amount of not less than $50,000.

Of the 656 notes sold during this period there were 649 notes sold which matured not more than one year from the date of issue and which were for an amount not less than $50,000.

With respect to the issue of these notes being "negotiable" the situation is less clear. It will be recalled that the 1981 legal opinion stated that the PGL notes - copies of which were attached to the opinion - were negotiable. The notes attached to the opinion contained the statement: "This promissory note shall not be assignable without the written consent of Principal Group Ltd."

The question arises as to whether this qualification on the assignability of the PGL notes makes the notes non-negotiable. If so, then the PGL notes would not have qualified for the exemption and would accordingly have been subject to the registration and prospectus requirements of the Act.

Certainly the legal opinion PGL relied upon stated clearly that the notes were negotiable. Johnston in Canadian Securities Regulation comments on the equivalent exemption section in the Ontario Securities Act:

> A promissory note in simplest terms is an unsecured promise to pay a certain principal amount. In practice it usually contains a covenant for interest payment and a specified term. In the exemption, the note must be negotiable, i.e., it must be capable of being assigned from its first holder to a subsequent holder. It is not clear why. Nor is it clear from the wording of the section whether the commercial paper must be negotiable as well. Inasmuch as the term seems to have only the vaguest of definitions anyway, any attempt to delineate it in a such a restrictive fashion would seem to be

contrary to the spirit of exemption.[9]

If Johnston is right that a negotiable promissory note is one that "...must be capable of being assigned" then PGL notes, although requiring PGL's approval prior to transfer, were "...capable of being assigned".

Notwithstanding the arguments that could be advanced with respect to the "negotiability" of the notes, one thing remains clear: trading in these notes took place as if the exemption was available. This meant that PGL did not notify the Superintendent's office of a sale either before, during or after it took place as it believed it was not required to under the Act. The consequence was that the Superintendent's office would not have had any knowledge of these sales unless there were complaints. Our examination of the records at the Superintendent's office and interviews with employees during the relevant time show neither any complaints about the sale of promissory notes nor any knowledge that these promissory notes were being sold during this period.

Accordingly, from November 3, 1981 to January 3, 1987, PGL raised approximately $65,000,000 on the exempt market through its sales of promissory notes under the commercial paper exemption without the knowledge of the Superintendent of Brokers.

B. THE SECURITIES ACT S.B.C. 1985

Between February 1, 1987 and June 30, 1987, according to the PGL log, PGL sold $13,171,742.58 in promissory notes in B.C. Of that amount, $10,481,329.78 was sold pursuant to the short-term note exemption and $2,690,412.80 was sold pursuant to the "acquisition cost" exemption. There were 115 short-term notes, and 21 "acquisition cost" notes for a total of 136 notes sold pursuant to the Securities Act, S.B.C. 1985.

The new short-term note exemption was found in section 32(d):

> 32. Except to the extent required by the regulations, a person may trade in the following securities without being registered under section 20(1):...
>
> (d) negotiable promissory notes or commercial paper maturing not more than 12 months from the date of issue so long as
>
> (i) each note or commercial paper is not convertible or exchangeable into or

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[9]Johnston, Ibid, at pg.227.

accompanied by a right to purchase another security other than a security described in this section, and

(ii) each note or commercial paper traded to an individual has a denomination or principal amount not less than a prescribed amount.

For the purposes of the new Act, the minimum dollar amount had been moved from the statute to the Security Regulation, presumably in order to make the amount easier to change should the need arise.

Section 77(4) of the Securities Act Regulation stated:

> For the purpose of section 32(d) of the Act, the denomination or principal amount of the note or commercial paper is not less than $50,000.

Once again, as with its predecessor, the exemption was automatic in that there was no need for PGL to have notified the Superintendent about the sales of these notes at any point.

In summary, between November 3, 1981 and June 27, 1987, PGL raised $74,527,921.00 through its sale of short-term promissory notes. These sales were exempt from both the registration and prospectus requirements of the B.C. Securities Act. PGL was not obliged to inform the Superintendent about these sales at any point, nor did it do so. As well, the Superintendent's office received no complaints about the sale of PGL notes in B.C. during this period.

3. THE ACQUISITION COST EXEMPTION

Between April 16, 1984 and June 13, 1987, PGL sold 26 notes in B.C. which had maturity dates exceeding one year and which, accordingly were not eligible for the short-term note exemption. The face value of these notes totalled $3,898,173.00. All but seven were sold after February 1, 1987.

As PGL sold these notes pursuant to exemptions under the Securities Act, R.S.B.C. 1979 and Securities Act, S.B.C. 1985, and because the provisions for these exemptions varied considerably, we will examine the sale of these notes under the different Acts separately.

A. THE SECURITIES ACT R.S.B.C. 1979

As noted, prior to embarking upon the sale of promissory notes, PGL secured an opinion from its legal counsel. With respect to notes maturing more than one year from the date of purchase, the 1981 legal opinion stated:

> 5. No registration is necessary and no prospectus need be filed in order that the Company may offer the Notes maturing more than one year but not more than five years from the date of issue in the Provinces of Alberta and Saskatchewan, to a purchaser who is a person, other than an individual or company who purchases for investment only and not with a view to resale or distribution if each of the said Notes has an aggregate acquisition cost to such purchaser of not less than $97,000 subject to:
>
> (a) the Company filing a report in Form 11 pursuant to The Securities Act (Alberta) where the purchaser of the Notes has an address in the Province of Alberta; or
>
> (b) the Company filing a report in Form 8 pursuant to the Securities Act (Saskatchewan) where the purchaser of the Notes has an address in the Province of Saskatchewan.
>
> Assuming that trades in the Notes maturing more than one year but not more than five years from the date of issue will not be made through an advertisement in printed media of general and regular paid circulation, radio or television, no registration is necessary and no prospectus need be filed in order that the Company may offer the Notes maturing more than one year but not more than five years from the date of issue in the Province of Ontario, to a purchaser who purchases as principal if each of the said Notes has an aggregate acquisition cost to such purchaser of not less than $97,000 and the Company files a report prepared and executed in accordance with the regulations under The Securities Act (Ontario) and required by subsection 71(3) of the said Act.

Three points can be noted from the legal opinion. First, Alberta and Saskatchewan had acquisition cost exemptions though these were not available to individuals. Second, Ontario had an acquisition cost exemption which was available to individuals. Third, B.C. is not mentioned because it had no acquisition cost exemption. It was not until October 19,

1983, that the B.C. Securities Act provided for an "acquisition cost" exemption by way of a regulation. Before proceeding to an analysis of the Securities Act, R.S.B.C. 1979, it is useful to examine the history of the "acquisition cost" exemption, for its roots are not the same as those which provided the short-term note exemption.

In 1966, as a result of several studies, Ontario introduced its new Securities Act, s.19(3) of which stated:

> (3) Subject to the regulations, registration is not required in respect of a trade where the purchaser is a person, other than an individual, or company who purchases for investment only and not with a view to resale or distribution, if the trade is in a security which has an aggregate acquisition cost to such purchaser of not less than $97,000.

Section 7 of the Regulations to the Ontario Securities Act stated:

> (7) Where a trade in a security is made under subsection 3 of section 19 of the Act, both the vendor and his agent, if any, shall, within 30 days after the sale of the security resulting from such trade, file with the Commission, for the use of the Commission, a report prepared in accordance with Form 8.

Form 8 required the vendor to provide some simple and straightforward information about the sale.

The rationale for the exemption as put by the Merger Report, 1970, was that it was designed:

> ...to overcome a reluctance on the part of large sources of capital within Canada and elsewhere which apparently could not be persuaded to apply for the exempt purchaser status.[10]

The $97,000 figure was selected to allow for the purchase of $100,000.00 of securities with the 3% brokerage commission

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[10]It will be recalled that "discretionary" exemptions were time-consuming as they required formal application to the Superintendent of Brokers, review by that office, and issuing of an Exemption Order - making any quick investment all but impossible.

deduction which was common at the time.

Alboini explains the reason for excluding individual investors:

> Individuals were excluded from the exemption under the Old Act, presumably to avoid the possibility of issuers or their agents soliciting those who were unsophisticated. In addition, it was assumed that individuals participating in a business organization would have some business experience and would seek out advice in connection with the proposed private placement whereas, for some reason, individuals would not.[11]

Alberta revamped its Securities Act in 1967 and s.19(3) of that Act essentially copied the Ontario provision.

B.C., which also revamped its Securities Act in 1967, did not copy the Ontario provision for an "acquisition cost" exemption.

In 1978, Ontario modified the acquisition cost exemption to allow "individuals" to purchase pursuant to it. Section 34(1)(5) read:

> 34.(1) Subject to the regulations, registration is not required in respect of the following trades:...
>
> 5. A trade where the purchaser purchases as principal, if the trade is in a security which has an aggregate acquisition cost to such purchaser of not less than $97,000.

The Ontario Securities Commission's Weekly Summary for the week-ending March 30, 1979 noted the rationale for removing the distinction between individuals and companies:

> It is hoped that the more flexible provisions of [s.34(1)(5)] will alleviate the rigid distinction that now exists between the markets for the two types of financing.

The Regulation required the filing of a "reporting" form with the Ontario Securities Commission. This form was known as a

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[11] V, Alboini, Ibid, at pp.440-441.

"Form 20" and closely resembled its predecessor, Form 8.

Alberta followed this practice under s.65(1)(e) of the Securities Act R.S.A., 1981. This extension of the exemption to individuals was assented to only one month after PGL's legal opinion was obtained (which presumably explains its absence in that opinion).

With respect to the situation in B.C., neither the 1979 Act nor the regulations made pursuant to it provided for an exemption for the sale of promissory notes for a period longer than one year. However, s.60 of Regulation 388/83, which came into existence on October 19, 1983 changed that:

> Section 6 and 36 of the Act [the registration and prospectus sections respectively] do not apply to a company that is an issuer with respect to a trade in a security which has an aggregate acquisition cost to the purchaser of not less than $97,000 where
>
> (a) a memorandum describing
> (i) the business and affairs of the issuer of the securities, and
> (ii) the purposes for which the net proceeds to be derived by the issuer are to be used
> is sent to the purchaser before an agreement of purchase and sale is entered into with the purchaser,
>
> (b) the memorandum referred to in paragraph (a) is filed with the Superintendent within five days after the date that it is sent to the purchaser, and
>
> (c) the purchaser purchases as principal.

If these conditions apply then the vendor need not be registered and a prospectus need not be provided, although there is the requirement that a copy of a memorandum (which is not defined) be sent to the Superintendent. This exemption has also become known as the "sophisticated investor" exemption.

During the time that this regulation was in effect (October 19, 1983 until March 20, 1985), PGL sold two notes exceeding a one year duration in B.C. according to the handwritten log. The records of the Office of the Superintendent of Brokers do not show or acknowledge receipt of a memorandum that would have been required pursuant to the new regulation although, as will be seen, there was such a memorandum in existence.

In the fall of 1984, PGL advised its Edmonton legal counsel that it was considering updating its Information Memorandum.

Counsel was asked to provide an opinion which would include the following terms:

> The Corporation may, either directly or through agents:
>
> (a) offer the Medium Term Notes[12] for sales in the Province of British Columbia to banks;
>
> (b) offer the Medium Term Notes for sale in the Province of British Columbia to trust companies registered under the Trust Companies Act (British Columbia);
>
> (c) offer the Medium Term Notes for sale in the Province of British Columbia to insurance companies registered under the Insurance Act (British Columbia); or
>
> (d) offer the Medium Term Notes for sale in the Province of British Columbia to parties recognized by the Superintendent of Brokers of the Province of British Columbia as exempt purchasers.

PGL's legal counsel contacted a Vancouver law firm on November 29, 1984, and requested its opinion with respect to the above-noted terms. Notably absent was a request for an opinion on an "acquisition cost" exemption.

On December 18, 1984, the Vancouver law firm sent a "draft opinion" which stated:

> No registration is necessary and no prospectus need be filed in order that the Company may offer, either directly or through agents, the Medium Term Notes in the Province of British Columbia to banks to which the Bank Act (Canada) applies, to trust companies registered under the Trust Company Act (British Columbia), to loan companies approved under the Trust Company Act (British Columbia), to insurers licensed under the Insurance Act (British Columbia), or to persons recognized by the British Columbia Superintendent of Brokers as exempt purchasers.

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[12]Medium Term Notes were defined in the legal opinion as having "...maturity dates from one year to not more than five years".

The Vancouver law firm was responsive to category (d) above but did not mention s.60 of Reg. 388/83 which would have allowed PGL to sell notes to individuals in B.C. pursuant to the acquisition cost exemption. It is not clear why.

On February 26, 1985, the Edmonton law firm wrote back with a revised auditor's letter and requested a revised draft opinion. A response came on March 1 in the form of a second draft opinion which stated:

> No registration is necessary and no prospectus need be filed in order that the Company may offer, either directly or through agents, the Medium Term Notes in the Province of British Columbia to banks to which the Bank Act (Canada) applies, to trust companies registered under the Trust Company Act (British Columbia), to loan companies approved under the Trust Company Act (British Columbia), to insurers licensed under the Insurance Act (British Columbia), or to persons, other than individuals, or companies recognized by the British Columbia Superintendent of Brokers as exempt purchasers. [emphasis added]

The underlined section indicates a revision of the former draft opinion and is based upon those portions of s.20(1)(c) of the Securities Act, R.S.B.C. 1979 which relate to the questions posed by the Edmonton law firm in its memorandum.

A few days later the Vancouver law firm was told that the auditor had issued yet another letter to reflect the fact that PGL had issued second preferred shares in late December, 1984. A lawyer's note on the file indicates, as well, that PGL was concerned that they not have to file an Information Memorandum in B.C., but that if they must do so then they did not wish to provide a purchaser with statutory rights of rescission.

On April 18, 1985, the Vancouver firm sent its opinion to the Edmonton law firm. This opinion served as the basis for the legal opinion contained in PGL's "Information Memorandum" for short and medium term promissory notes dated March 1, 1985, section 5 of which states:

> No securities legislation registration is necessary and no prospectus need be filed in order that the Corporation may offer the Notes maturing more than one year but not more than five years from the date of issue ("Medium Term Notes") either directly or, except in the Province of Newfoundland, through agents...
>
> (e) to parties recognized by the respective securities administrators of the Provinces of Alberta, British Columbia, Saskatchewan, Ontario, New Brunswick,

Nova Scotia, Prince Edward Island and Newfoundland as exempt purchasers under their respective statutes, provided that in the Provinces of Alberta and Ontario the exempt purchaser purchases as principal; or

(f) to purchasers in the Province of Alberta, Ontario and Saskatchewan who purchase as principal and incur an aggregate acquisition cost of not less than $97,000, provided that in the Province of Saskatchewan such purchaser must be a person, other than an individual as defined in The Securities Act (Saskatchewan), or a company who purchases for investment only and not with a view to resale or distribution.

Meanwhile, Regulation 388/83 was repealed in B.C. effective March 21, 1985. The revised regulation read as follows:

(60) Section 6 and 36 of the Act do not apply to a trade that consists of the issue of a security at an aggregate acquisition cost to the purchaser of not less than $97,000, where

(a) the issuer is a reporting company whose common shares constitute an investment in which a company registered under Part 3 of the Canadian and British Insurance Companies Act (Canada) is authorized by the Act, other than by section 63(4) of that Act, to invest its funds,

(b) the purchaser purchases for investment purposes only and not with a view to resale or distribution, and

(c) a memorandum describing the business and affairs of the issuer of the security and the purposes for which the net proceeds to be derived by the issuer are to be used

(i) is sent to the purchaser before an agreement of purchase and sale is entered into with the purchaser, and
(ii) is provided to the Superintendent within five days after the date that it is delivered to the purchaser,

if the offer and sale of the securities is accompanied by an advertisement.

Therefore as of March 21, 1985, to be eligible for the "acquisition cost" exemption, one needed to be a reporting company whose common shares constituted an investment of a type in which a company registered under the Canadian and British Insurance Companies (Canada) Act was authorized by that Act to invest its funds. As well, a purchaser could only purchase for investment purposes. In the event of a sale, a memorandum describing the business and affairs of the security issuer and the purposes to which the net proceeds were to be used was to be sent to the purchaser before sale and to the Superintendent within five days of the sale if the offer and sale of the securities was accompanied by an advertisement.

The amended regulation 60 was in effect in B.C. until January 31, 1987. During that time, five acquisition cost exempt note sales were made by PGL in B.C. It is worth noting that during this time, when presumably this exemption was being relied upon, PGL was not a reporting company, which meant that the exemption was not open to it. The consequence was that the people selling the securities should have been registered and a prospectus should have been filed with, and approved by, the Superintendent unless discretionary exemptions were granted in these cases. There is no indication that discretionary exemptions were granted. However, no complaints were received by the Superintendent's office during this time and our interviews revealed no one at the Superintendent's office who knew of the sale of any promissory notes at this time.

B. THE SECURITIES ACT S.B.C. 1985

Between February 1, 1987 and June 30, 1987, according to the PGL log, PGL sold 21 notes in B.C. totalling $2,690,412.80 pursuant to the "acquisition cost" exemption.

The new Securities Act which came into effect on February 1, 1987, refined the "acquisition cost" exemption. Section 31(2)(5) provided the exemption from the registration requirement:

> (2) Except to the extent required by the regulations, registration under section 20(1) is not required for the following trades:...
>
> > (5) a trade where the person purchases as principal, and the trade is in a security which has an aggregate acquisition cost to the purchaser of not less than a prescribed amount...

The prescribed amount was contained in Regulation 77(1):

77.(1) For the purpose of section 31(2)(5) of the Act, the aggregate acquisition cost to the purchaser is not less than $97,000.

The exemption from the prospectus requirement was contained in s.55(2)(4):

(2) Subject to additional requirements of the regulations, section 42 does not apply to a distribution where...

(4) the person is purchasing as principal, and the trade is in a security which has an aggregate acquisition cost to the purchaser of not less than a prescribed amount...

The prescribed amount was contained in Regulation 118(1):

118.(1) For the purpose of section 55(2)(4) of the Act, the aggregate acquisition cost to the purchaser is not less than $97,000.

However, Regulation 132 required that PGL "report" any sales made pursuant to this exemption within 10 days.

132.(1) Subject to subsection (2), where an issuer distributes a security under section 55(2)(1) to (5), (8) to (10), (11)(i), (14), (16)(i), (18), (19) or (24) to (27) of the Act or section 117(a), (b) or (f) to (i) of this regulation, the issuer shall file a report in the required form not later than 10 days after the distribution.

The records show that 21 long-term notes were sold in B.C. after February 1, 1987 and that reports of those sales were received by the B.C. Securities Commission.

4. THE POWER TO REMOVE EXEMPTIONS

S.145 of the Securities Act, S.B.C. 1985 provides:

145. (1) Where the commission or the superintendent considers it to be in the public interest, it or he may, after a hearing, order that any or all of the exemptions described in any of section 30 to 32, 55, 58, 81 or 82 do not apply to a person.

(2) Where the commission or superintendent

> considers that the length of time required to hold a hearing under subsection (1) could be prejudicial to the public interest, it or he may make a temporary order, without a hearing, to have effect for not longer than 15 days from the date it is made.

The 1979 Act did not have an equivalent section, although both Acts vested in the Superintendent the power to issue a Cease Trade Order where such an Order would have been in the public interest.

An Order removing PGL's exemptions would have meant that, prior to selling any further notes, PGL would have to register its sales force and prepare and submit to the Superintendent a prospectus for approval.

Given that the legislation requires the Commission or Superintendent to conclude that the issuance of such a removal of exemption Order is in the public interest, prior to the making of such an order it would have been necessary for the Commission or Superintendent to determine that the issuance by PGL of its notes was not in the public interest. Depending upon the information available to the Commission or the Superintendent prior to the collapse of the Principal Group, it may have been appropriate for such a removal of exemption Order to have been made.

IV. WHAT THE REGULATORS KNEW

1. BEFORE FEBRUARY 1, 1987

Although regulators had expressed concern in the early 1980's about the sales practices of some Principal Consultants Ltd. salespeople who operated out of Principal Savings & Trust, there appears to have been no actual knowledge by the regulators of the sale of PGL promissory notes in British Columbia prior to March 6, 1987. Chapter V of the B.C. Ombudsman Report No.19 provides further detail about the regulation of Principal Savings & Trust during the 1980's.

The situation in Alberta was different. The report of the Alberta Ombudsman indicates that the Director of the Enforcement Section of the Alberta Securities Commission not only knew about, but in 1985 reviewed, PGL's sale of promissory notes in Alberta and was disturbed by

> ...the apparent classical ponzi scheme where new investors' monies are used to pay old investors out, the key being that there is an appreciable time delay in paying out the early investor.[1]

The Chairman of the Alberta Securities Commission told the Alberta Ombudsman that this investigation report had never been brought to his attention. There is no evidence that this information about note sales in Alberta was passed on to regulators in B.C.

As Public Report No. 19 outlined, regulators in B.C. had a clear statutory duty under the Investment Contract Act to monitor and regulate the investment contract companies AIC and FIC, operated by the Principal group of companies. B.C. officials relied on regulators in Alberta for information about the financial status of the investment contract companies, whose assets were largely based in that province. Initial inquiries into the financial status of PGL were made in the context of evaluating the solvency of the investment contract companies. The report of Inspector William E. Code Q.C., who conducted an Inquiry into the reasons for the failure of AIC/FIC and the regulation of those companies in

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[1]Office of the Ombudsman, Special Report. The Role of the Provincial Government in the Regulation of the Principal Group of Companies 1989. Province of Alberta, pp.337-340.

Alberta, indicates that the Alberta regulators had been less than forthcoming with their B.C. counterparts in providing information.[2]

Michael C. Ross was appointed Superintendent of Brokers in B.C. on June 23, 1986. The first evidence of an attempt to examine the financial statements of the network of companies was a July 4, 1986 letter sent out under his signature. In that letter, a request was made for PGL's financial statements as one of several requirements before B.C. would consider renewing AIC's and FIC's registrations. Mr. Ken Marlin, Vice-President of PGL, responded that since PGL was a private company, the directors and shareholders had indicated that they were not prepared to release the financial statements. He added that Mr. Ross or Mr. Smith of the B.C. Superintendent's office could review the financial statements at a meeting scheduled for July 31, 1986. Mr. Smith stated to this office that as he was not allowed to photocopy the financial statements and was not given sufficient time to review them usefully, he declined to review them at all. There was no requirement that Mr. Smith should conduct an investigation into the solvency of companies other than the investment contract companies.

Our Public Report No.19 on AIC and FIC documents the concern Mr. Smith had about the potentially serious financial situation of the investment contract companies. In November, 1986, Mr. Smith wrote to Mr. Ross commenting that the quarterly financial statements for AIC and FIC indicated substantial losses for the first nine months of 1986 and suggesting immediate action by Mr. Ross. Mr. Ross discussed with an Alberta official the appointment of independent consultants who were to be hired to investigate the solvency of the investment contract companies.

2. AFTER FEBRUARY 1, 1987

Michael Ross resigned from his position on February 2, 1987 and David Sinclair became Acting Superintendent. On February 20, 1987, the accounting firm hired to conduct the independent review of the investment contract companies delivered a preliminary report to the Alberta regulators stating that the investment contract companies were in financial difficulty. The consultants expressed serious concern that they had not been able to obtain information with respect to the companies' real estate assets, and their transactions with the related companies. One of those related companies was PGL.

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[2]William E. Code, Q.C. Final Report of the Inspector, July 18, 1989. Alberta.

The draft preliminary report of the consultant was received by Alberta regulators on February 20, 1987. On February 27, 1987, an Alberta regulator advised a B.C. official that the consultant's report was not yet complete, but that it would be in draft the following week. Mr. Smith was to be sent to Alberta to review it on March 10. Despite their request to the Alberta officials that they be kept informed about the status of the investment contract companies, regulators in B.C. did not receive a copy of that draft preliminary report until March 16, 1987.

On March 23, 1987 David Sinclair wrote to the Minister of Finance and Corporate Relations expressing his concern about the precarious financial situation of AIC and FIC. He noted that Alberta had prime jurisdiction and he advised the Minister that suspending or cancelling the registration of AIC and FIC would likely bring about an immediate collapse of those companies. He concluded that until a complete assessment was made and time was given to develop possible solutions, cancellation of registration would not be a prudent step.

On the same day, Mr. Sinclair wrote to the Assistant Deputy Provincial Treasurer in Alberta stating that B.C. had no choice but to renew the registrations of AIC and FIC, since to withhold approval would precipitate a collapse. However, he cautioned that B.C. was not prepared to see the matter drawn out and warned that "grave and urgent action" was needed.

On April 6, 1987, Mr. Sinclair emphasized in a letter to Mr. Kalke, Alberta's Deputy Provincial Treasurer, that the final report of the independent consultants regarding the investment contract companies would have to arrive at a comprehensive evaluation and assessment of the assets. He stated that while all the assets had to be looked at, the key elements were the investments in, and loans and advances to, companies within the Principal group, together with the real estate and mortgage portfolio. He again stated that the situation could not be expected to continue much longer without firm action being taken.

On April 27, 1987, Alberta and B.C. regulators met in Edmonton to discuss their concerns about the financial health of AIC and FIC. Notes of that meeting refer to a letter from the Alberta authorities calling for an injection of $50-60 million into AIC and FIC. The letter had asked the companies to respond by May 12, 1987. The notes go on to state that the accounting firm's final report had been delayed because of the reticence of Principal executives to provide the financial statements of Athabasca Holdings and PGL.

On April 30, Mr. Smith sent a memorandum to David Sinclair

noting that he had told Mr. Marlin of PGL that either they put $50 million into AIC and FIC or turn over the financial statements of Athabasca and PGL.

Once again, on May 7, 1987, regulators from B.C. met with Alberta officials. The discussion focused on the serious financial problems of the investment contract companies and the need of the regulators to understand the inter-company transactions. The meeting generated a plan of action which established that a business plan for each of the companies had to be drawn up within three weeks and that Principal officials were to meet with officials of the Alberta Treasury every four days. David Sinclair asked for complete financial statements for all the companies. Furthermore, a meeting was scheduled with CDIC officials and regulators from both provinces for May 20, 1987.

On May 8, 1987, a letter was sent to Mr. Sinclair from John Agrios on behalf of the Principal Group stating that financial statements for the Principal group of companies would be forwarded "in the next few days". On May 20, 1987, Mr. Agrios wrote again to Mr. Sinclair enclosing a number of documents and stating that "within the next day" the company would provide the financial statements of the Principal group of companies as at December 31, 1986.

On May 22, the accounting firm conducting the independent review of AIC and FIC wrote to the Alberta Treasury and included a second draft report. A copy of this draft was sent on May 25, 1987 to an assistant to the Acting Superintendent of Brokers in B.C.

Following receipt of the second draft of the independent auditor's report and with awareness of the obviously deepening financial crisis, British Columbia regulators met with Alberta officials on the morning of June 3, 1987, and later on the same day with Principal officials. A memorandum of that meeting prepared by Mr. Sinclair's independent consultant reported that at the first meeting, an Alberta official advised that a further $90 million in promissory notes payable had been discovered in the liabilities of PGL, a factor which he said could further complicate both the anticipated shortfall and the legal aspects of any liquidation procedure. Mr. Kalke also said that PGL executives had agreed to accept no new monies through FIC and AIC.

The Principal representatives at the meeting presented eight scenarios for a bailout scheme. One of the arguments they put forward for government support was that a bailout would protect outstanding PGL notes. The Principal representatives warned:

> ...without government support the income needed from commission income and administration income would dwindle and expose noteholders of PGL to substantial losses likely between $70-90 million.

According to notes of the meeting, Mr. Sinclair outlined B.C.'s position, including the requirement that a pledge of all assets of PGL and any affiliates be assigned immediately. Mr. Sinclair also stated that the B.C. government had no confidence in the integrity and ability of the companies' management and would not provide any financial support for a bailout.

The notes of Mr. Sinclair's assistant record the first evidence of knowledge by senior B.C. regulators that promissory notes were being sold in B.C. He wrote:

> The $90 million in note liabilities in PGL is 30% to the Hutterite Community, balance to mainly sophisticated individual investors in Alberta. Would estimate $15/20 million in B.C.

The memorandum ends by stating that David Sinclair would submit a report to the Minister of Finance and Corporate Relations and that B.C. would await Alberta's decision on June 10 regarding financial assistance to the companies. Mr. Sinclair's assistant suggested that otherwise June 15 should be the latest date for action on the part of B.C.

On June 1, 1987, Neil de Gelder took office as Superintendent of Brokers. Mr. Sinclair's involvement ended with his memorandum to the Minister of Finance and Corporate dated June 4, 1987. In his final memorandum he described the investment contract companies as insolvent and set out the various scenarios suggested by the PGL officials at the June 3 meeting. Mr. Sinclair also referred to the promissory notes in the memorandum:

> In addition to the above liabilities of the investment contract companies, there is some $90 million in debt of the Principal Group holding company for which Government contingency back-up financing was needed. (Of this $90 million some $30 million was held by the Hutterite community.)

Mr. Sinclair advised the Minister that company officials had indicated that they would immediately stop taking in new deposits, but would do this quietly so as not to create panic. He stated that if Alberta allowed the problem to go unresolved for much longer, then June 18 or June 22 should be a deadline date for B.C. to take action. Mr. Sinclair said that an

orderly approach to the situation was required so that if bankruptcy resulted, a liquidator, receiver or trustee would have the necessary powers to take control of the assets. He reported that he had told Alberta B.C. would be prepared to withdraw registration of the investment contract companies unilaterally if necessary, but that the consequence of that step would be to "...bring about the collapse of FIC and AIC and other companies in the Principal Group since depositors would seek recovery of their funds and a liquidity crisis" would ensue. In his opinion such unilateral action would be "a last resort" in the event that Alberta was not taking vigorous enough action.

On June 4, 1987 Mr. Sinclair's assistant wrote to Mr. Sinclair that the Alberta Treasury "...appeared to be willing to let the matter drag on hoping that improvement of equity would come from sale of assets or raising of new capital". He suggested July 1, 1987 as a target date for suspension of the investment contract companies' licences if there was no improvement in the companies' equity by then.

While B.C. regulators awaited Alberta's decision with respect to a possible bailout, Principal executives were concerned with raising new capital. Documents released during the Code Inquiry reveal the "behind-the-scenes" situation.

On June 2, 1987, a memo was sent from Mr. Marlin to managers and senior personnel ordering that until further advised all new money coming in must be taken into Principal Savings & Trust, Principal Group notes or mutual funds. Further, on June 5, 1987, a memo went out to Principal staff that FIC/AIC term certificates would be offered to maturing term certificate customers only, and that those clients could add new money to their roll-overs.

On June 9, another internal directive was sent out to Principal staff ordering that no new AIC or FIC term certificates were to be sold, but that roll-overs from existing FIC and AIC plans would be allowed, and new funds could be added to those plans. On the following day, Mr. John Agrios, a lawyer who had attended the meetings between PGL and the regulators wrote in an internal letter to Donald Cormie to assert that under the terms of their agreement with the regulators there was to be no new investment program. He wrote:

> With respect to the PGL Notes, we wish to confirm that a trust is being established in relation to all "new investor money". Of concern though is the fact that we have been apprised that major charitable institutions have been aggressively approached to invest in PGL Notes. This is highly objectionable and cannot be condoned at

this time. It is our understanding that new investors will not be aggressively sought for PGL Notes and that the current program is merely being maintained to facilitate those investors expressing a desire to participate in the program. We must ask for immediate assurances that this will in fact be the policy followed by the Principal Group until further direction.

On June 24, PGL inter-office correspondence referred to a letter from Mr. Agrios on May 26 regarding the establishment of a trust arrangement for new money taken in on PGL notes after May 20, 1987. The memorandum written by a PGL official states that "...different people see different problems with this arrangement", and therefore until "such matters" were settled, and in order to expedite the trust arrangement, certain mutual funds were designated to be held for the benefit of the "new" money note holders.

On July 2, 1987, B.C. cancelled the licences for the investment contract companies, AIC and FIC, the next business day after Alberta had done so. The Minister of Labour and Consumer Services appointed Lyman Robinson, Q.C., as Commissioner of Inquiry to investigate FIC, AIC, PGL, PS&T and PCL pursuant to section 12 of the Trade Practice Act. The Commissioner's mandate was to determine whether the companies had engaged in misleading or deceptive acts or practices in respect to consumer transactions pertaining to investments.

Regulators in Alberta held a hearing on July 17 and as a result of the hearing denied PGL the use of exemptions for its sales of promissory notes, effective July 1, 1987; all monies received for the purchase of notes from July 1, 1987-July 17, 1987 were ordered to be returned.[3] Two of the purchasers who had money returned in that period resided in B.C. but had purchased the notes in Alberta.

A report of a meeting which took place in Alberta among CDIC officials and senior B.C. and Alberta officials on July 20 discussed the status of the Principal Savings & Trust and the need for further information regarding its financial position and that of PGL.

On July 27, 1987, Lyman Robinson, who was beginning his inquiry into the sales practices of the Principal group of companies, contacted H.A. Dilworth, the Director of the Investigation Branch at the B.C. Superintendent of Broker's office. In a memorandum to the chairman of the B.C. Securities Commission on the same date Mr. Dilworth reported:

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[3]Ombudsman of Alberta, Special Report, p.340.

RE: FIRST INVESTORS' CORPORATION LIMITED, ET AL
In the a.m. of 27 Jul. 87, I had a telephone call referred to me by the Superintendent's secretary, from Lyman Robinson, Q.C., in regard to the above companies. ROBINSON said he had learned at a meeting in Alberta that PRINCIPAL GROUP LTD. had been issuing promissory notes in the province of Alberta and Alberta had ceased traded them in this regard. Robinson asked me if PRINCIPAL GROUP LTD. were issuing promissory notes in this province. I said that I did not know, but would check into this and contact him.

A check of the computer screen showed that PRINCIPAL GROUP LTD. has a two file and on looking at the two file, which was in records, they had been issuing promissory notes under the exemption of the Securities Act under 55(2)(4), which is basically the $97,000.00 rule. The file contained numerous form 20's, which is a form they must file for this exemption. This information was immediately brought to the attention of yourself and Gordon Mulligan (Deputy Superintendent of Brokers) was called to the meeting and informed of the above information. It was requested that MULLIGAN check into the circumstances and if Alberta had, in fact, removed the trading exemption and/or had ceased traded the company and why they had not informed us of this action directly.

I contacted ROBINSON by telephone later in the p.m. and advised him there were promissory notes issued under the 55 exemption and that the appropriate action was being carried out in this regard by your office.

Robinson also said that he would be faxing a summons over as to the files that our office had in regard to the various PRINCIPAL companies...

Later in the p.m. of 27 JUL 87, Gordon Mulligan telephoned me and said that he had spoken to Alberta and they had, in fact, removed the trading exemptions, but had only taken this action on 24 JUL 87, and were intending to notify us...

On July 31, 1987, the B.C. Securities Commission issued an order pursuant to section 145 of the Securities Act for the removal of exemptions in relation to a number of Principal Group companies, including PGL. Subsequent orders and variations were issued precluding the companies from taking advantage of a blanket order and other securities exemptions. On August 10, 1987, on the basis of recommendations by Lyman Robinson, the Director of Trade Practices filed a writ of

summons naming Principal Savings and Trust, Principal Group Ltd. and Principal Consultants Ltd. as defendants. Orders were also made to freeze the assets of those companies in B.C.

On August 10, 1987, the Principal Group Ltd. was voluntarily assigned into bankruptcy.

The new Securities Act had come into effect on February 1, 1987. It introduced the requirement that a form be completed and sent to the B.C. Securities Commission within ten days of the distribution of a promissory note for an amount over $97,000 with a term in excess of one year. This form was called a Form 20. The result of this requirement was that while senior regulators were increasingly aware of a possible collapse of the Principal Group of Companies, information was being received at a clerical level about the sale of promissory notes in B.C. It does not appear, however, that that information reached these senior regulators and even if it had it would not have provided evidence about the solvency of PGL.

The first record of the B.C. Securities Commission receiving information related to a PGL note sale was a letter sent to the Commission by PGL on March 5, 1987, enclosing two completed forms which were stamped as received on March 6, 1987. Only one of these forms is in the file of the Commission. PGL sent in a record of four separate transactions on two forms, so that although there were 21 note sales, there were only 19 forms, one of which is missing. The last two forms were received on June 27, 1987.

The forms were processed by a Filings Officer who had responsibility for this area. Upon receipt of a Form 20, she completed a checklist to ensure that all required information had been properly provided and she then entered this information into the computer. A compilation of these exemptions was printed along with records of other security transactions in a Weekly Summary. This Weekly Summary was circulated within the Securities Commission and was also distributed by the Vancouver Stock Exchange.

According to the Filings Officer, her only monitoring of these forms consisted of checking that the distribution date had been properly completed and that the correct section of the Act had been circled with respect to the type of exemption used. She recalled discussing the category under which promissory notes were to be recorded in a general way with the Director of Filings, since there was no code under the Securities Act sections pertaining to note sales. It was decided to list them as debentures. She did not recall mentioning that these were PGL notes. Although she did not receive many promissory note forms, the overall volume of

forms she had to process was high.

In summary, although there were records of sales of promissory notes by PGL between March 6, 1987 and June 27, 1987, the information provided on the forms was of a routine nature and provided no information regarding the solvency of the companies or the level of sophistication of the purchasers.

V. ANALYSIS

As noted earlier, the tragedy for many of the PGL noteholders was distressingly simple: they bought a financial product without understanding the risks involved and they lost most of their money. Having seen how this came to pass we must now ask whether the regulators were at fault for not stopping it from happening. In particular, we must ask whether the regulators ought to have removed PGL's exemptions before they did on July 31, 1987.

We must also ask whether there are lessons that may be learned from the experience of the PGL noteholders which might lessen the likelihood of such a tragedy happening again.

Section 10(1) of the Ombudsman Act states:

> 10.(1) the Ombudsman, with respect to a matter of administration, on a complaint or on his own initiative, may investigate
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> (a) a decision or recommendation made;
> (b) an act done or omitted; or
> (c) a procedure used
>
> by an authority that aggrieves or may aggrieve a person.

In B.C. Development Corporation vs. Friedmann (1985) 1 W.W.R., 193 Dickson, C.J.C., in a unanimous opinion, interpreted the phrase "a matter of administration" as follows:

> In my view, the phrase 'a matter of administration' encompasses everything done by governmental authorities in the implementation of government policy. I would exclude only the activities of the legislature and the courts from the Ombudsman's scrutiny.

As stated by the Chief Justice, it is the Ombudsman's role to investigate complaints about the implementation of government policy. It is not the role of the Ombudsman to take the place of the legislature in determining what government policy ought to be.

The situation brought about by the sale of PGL promissory notes in B.C. involves a unique set of circumstances. It is necessary to analyze three separate yet connected elements: the legislators, the statute (the Securities Acts) and the regulators.

1. THE ROLE OF THE LEGISLATORS

In a democratic society, citizens elect the government of their choice. It is the role of legislators to shape and establish public policy. This process is carried out in the open and is subject to debate in the legislature by elected individuals representing a variety of viewpoints.

In establishing public policy, the legislators must often weigh competing demands and in that weighing, determine how best to allocate the taxpayers' money. Once established, policy is set out in a statute.

The statute becomes the written representation of the legislators' ideas. Administrators or regulators are then charged with the responsibility of carrying out the legislators' policy as that policy is stated in the words of the statutes. It is neither the duty nor the right of regulators to determine what public policy should be. Nor do regulators have the right to exceed the powers granted to them under the statute.

What is clear from our investigation is that, as a matter of public policy, the legislators were of the view that the sale of certain promissory notes should be exempt from the registration and prospectus requirements of the Securities Act. It was believed that by allowing these exemptions, more capital would be available for the investment market. It was also believed that if the minimum investment figure was pegged sufficiently high, then an investor would not need the protection provided by the Securities Act. In essence, a relationship was assumed between an investor's sophistication and his or her possession of a certain minimum amount of investment capital.

2. THE B.C. SECURITIES ACTS

The assumption that a specified minimum amount of money relates to sophistication led to certain securities exemptions being expressed in monetary terms. An individual who wished to invest a minimum of $50,000 over the short-term, or $97,000 over the long-term, could make purchases on the exempt market. In the short-term case, the Securities Act did not require the vendor to inform the Superintendent's office at any time of the transaction. In the long-term case, at least after February 1, 1987, the Superintendent's office would be notified after the sale by way of a Form 20.

It should be noted that Form 20's were not equivalent to financial statements. In other words, from a reading of the Form 20 one would not be able to discover any useful

information about the financial status of the issuer. It was not the purpose of the Form 20 to provide the regulator with financial information which would assist in determining whether or not a particular investment was a sound one.

According to the British Columbia Securities Commission, Form 20's served the following purpose:

> A Form 20 is filed by the issuer in order to facilitate the collection of fees; to ensure that claimed exemptions are, at least on the face of the Form 20, properly used; and to keep a statistical record of certain exempt distributions that is published in the Commission's 'Weekly Summary'. The 'Weekly Summary' is circulated to approximately 300 subscribers -- including issuers, law firms, consultants, brokerage firms, accounting firms, transfer agents, other securities commissions, the Vancouver Stock Exchange and Toronto Stock Exchange, universities, self-regulatory organizations, the Financial Post, CCH Canadian Limited and various libraries including the Vancouver Public Library.

Whatever the purpose, Form 20's clearly were not used to indicate the financial solvency of the issuing company.

If the Superintendent wished to regulate these exempt sales (i.e. subject them to the registration and prospectus provisions), then the only option was to issue a Removal of Exemption Order pursuant to s.145 of the Securities Act, S.B.C., 1985. However, this power was only to be used when the Superintendent considered that to do so would be "...in the public interest".[1]

3. THE ROLE OF THE REGULATORS

For the purpose of this review there are three categories of financial transactions:

1. transactions that are not covered by the Securities Act;

2. transactions that are covered by the Securities Act and are subject to the registration and prospectus provisions; and

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[1]The power to remove these exemptions arose under the Securities Act, S.B.C. 1985. However, both the Securities Act, R.S.B.C. 1979 and the Securities Act, S.B.C. 1985 had a section granting power to the Superintendent to order a halt in trading in these promissory notes if, once again, he determined it to be "...in the public interest".

3. transactions that are covered by the Securities Act but are exempted from the prospectus and registration provisions and are thereby essentially unregulated.

The PGL promissory notes were marketed as exempt transactions. The Superintendent could only remove these exemptions if he considered it to be "...in the public interest".

In his book Securities Law, Alboini outlines the five circumstances which constitute "public interest" developed by the Ontario Securities Commission:

1. abuse of the exemptions;
2. contravention of the Act, regulations or policies;
3. take-over bids;
4. contravention of the Toronto Stock Exchange's requirements;
5. contravention of other statutes affecting public policy or concern in the securities industry.[1]

The question with respect to the PGL notes is whether the Superintendent of Brokers should have removed PGL's right to the exemptions it utilized in selling its notes before July 31, 1987. More pointedly, were there "public interest" justifications for the removal of those exemptions in B.C. prior to July 31, 1987?

There are a few general observations to be made before examining this question. They are:

1. PGL sold its promissory notes in B.C. pursuant to statutory provisions which exempted these sales from the registration and prospectus requirements of the Securities Act.

2. The power to remove these exemptions is found in section 145 of the Securities Act, S.B.C. 1985 and arose on February 1, 1987. S.145 states:

> "S.145(1) Where the commission or the superintendent considers it to be in the public interest, it or he may, after a hearing, order that any or all of the exemptions described in any of section 30 to 32, 55, 58, 81 or 82 do not apply to a person.
>
> (2) Where the commission or the superintendent considers that the length of time required to hold

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[1] V. Alboini, Securities Law and Practice (Toronto: Carswell, 1984-), at pp.21-42 and 21-43.

> a hearing under subsection (1) could be prejudicial to the public interest, it or he may make a temporary order, without a hearing, to have effect for not longer than 15 days from the date it is made...

3. The power to issue a Removal of Exemption Order is discretionary and arises only when the Superintendent or Securities Commission considers that the making of it is "...in the public interest".

4. The "public interest" includes, but is not limited to, "investor protection". The "public interest" can also include the need to attract capital and provide a stable marketplace.

"Investor protection" itself can mean either the protection of investors' money already invested or the protection of investors' money not yet invested. For example, if PGL's exemptions had been removed on March 1, 1987, then those investors who bought PGL promissory notes between March 1, 1987 and June 30, 1987, (106 promissory notes were sold during this period) would not have lost the money that they did. At the same time, however, those investors whose investments matured between March 1, 1987 and June 30, 1987 (103 promissory notes matured during this period) would have lost money if the result of lifting the exemptions caused PGL to collapse.

Let us now turn our attention to the issue of whether or not the Superintendent of Brokers should have removed PGL's exemptions prior to July 31, 1987.

To remove an exemption "in the public interest", a regulator must first perceive some "danger" to the public interest and then weigh the consequences of removing that specific "danger" in the overall context of the public interest.

With respect to the sale of PGL notes in British Columbia, the "danger" to the public interest could have been defined as either or both of two things:

1. that PGL was either bankrupt or on the verge of bankruptcy;

2. that the purchasers of PGL promissory notes were not the "sophisticated investors" that the statute envisioned.

If we begin by examining the situation with respect to the financial stability of PGL, it seems reasonable to say that prior to June 3, 1987, B.C. regulators would not have had sufficient information to determine accurately the financial

status of PGL.

It is fair to state that actions taken by B.C. regulators prior to June 3 indicate that they had initially viewed PGL as a source of income for supporting AIC and FIC and not as a liability itself. Until David Sinclair received the independent auditor's February 20, 1987 draft report on March 16, there was no reason to think otherwise as in the past PGL had apparently injected money into AIC and FIC, and there were no records of any complaint to the Superintendent about PGL's sale of promissory notes in B.C.

As a result of that report, meetings were set up in spring of 1987. As contact with the Alberta regulators increased, so did the B.C. regulators' knowledge about the interconnection of the Principal companies. That knowledge expanded considerably when meetings were held with executives of the Principal group of companies in May and June. The second draft report of the independent auditor was received on May 22, 1987. There was no final report issued. Clearly, on June 3, 1987, when the Principal executives presented their eight "bail-out" scenarios to the Alberta and B.C. regulators, the extent of the problem became known. It also became clear that not only was PGL not a potential source of support for AIC and FIC, but also that it had outstanding liabilities of approximately $90 million, $15-20 million of which was owed to "sophisticated" investors in B.C.

With the knowledge that they acquired on June 3, it would be reasonable to expect the B.C. regulators to consider cancelling the licences of AIC and FIC and removing PGL's exemptions. The regulators, however, did not cancel the registration of AIC and FIC at that time. They were hoping during early June that the Alberta Government might come up with a bail-out proposal for the companies. If Alberta would do so then there was reason to hope that B.C. investors - whether in investment contracts or promissory notes - might be rescued.

The approach taken by both David Sinclair and Neil de Gelder was one of recognizing that the financial problems were not restricted to any one company but rather were endemic to the whole group; one could not simply deal with the problems of one company in this web.

The B.C. regulators faced a serious dilemma. If they moved swiftly to remove PGL's exemptions and cancel AIC and FIC's licences before seeing whether Alberta would bail-out the companies then they risked causing losses to current investors. If, however, they waited and Alberta did not provide a "bail-out" then innocent new investors would lose

money.[3]

The evidence we have indicates that both David Sinclair and Neil de Gelder were sensitive to both sides of this issue and decided on a course which gave a limited amount of time to the Alberta authorities to decide whether or not to bail-out the companies in the hopes that this would lessen the financial impact upon British Columbia investors. It was in our view reasonable for the B.C. regulators to provide a limited period of time to the Alberta authorities to see whether or not Alberta would bail out the failing companies.

It is fair to say, however, that following the cancellation of the registrations of AIC and FIC, it became appropriate once again for the Superintendent of Brokers to consider removing PGL's exemptions. It appears that Mr. de Gelder did not.

We stated that a second danger would have arisen if the Superintendent recognized that the purchasers of PGL promissory notes were unsophisticated.

PGL followed the letter but not the spirit of the exemptions law. That law in effect stated that if a person had either $50,000 or $97,000 to invest (depending upon which of the notes they were purchasing), then that individual was taken to be sophisticated. Clearly, PGL targeted individuals who did have that amount of money while knowing at the same time that most of them were not the sophisticated investors that the drafters of the statute intended them to be.

It appears from the evidence and documents we have examined that the Superintendent's office did not recognize until at least late July or August 1987 that the purchasers of PGL notes were not sophisticated - at which point the exemptions were removed.

In an interview with our office, related to Public Report No. 19, Mr. de Gelder contrasted his description of the purchaser of a promissory note with his description of the purchaser of an investment contract:

> And when you look at whose interests we are protecting, I know this may sound unfair and in retrospect it

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[3]The Trustee in Bankruptcy for PGL has provided us with the following information. During the month of June 1987, 68 PGL notes came due. Of these, 37, having a value of approximately $4,355,000, "rolled-over" into new PGL notes. The other 31, having a value of approximately $5,547,000 were paid out. From July 1, 1987 to August 7, 1987, all PGL notes which matured appear to have been paid out - there were 108 having a value in excess of $13,000,000.

> probably wasn't right, I don't know, but we looked at people who thought that they were buying investment contracts and who were very heavily, very significantly undersecured and who had bought under what was supposed to be a regulated regime, the Investment Contract Act. Those investors are an entirely different class of investors than the ones that buy commercial paper in the money market.
>
> ...our view was listen, if there are people who want to put money into the money market to prop up Principal Group so that it can meet its obligations to the investment contract companies, that's good because they know what they are buying and what the exposures are. And I am not sure that decision was right or wrong. It just turns out that afterwards we found out who had been buying a lot of these promissory notes, and maybe they weren't all that sophisticated.

If one asks the further question of when might the Superintendent have known that these purchasers were unsophisticated, then the earliest date might have been March 6, 1987, when the first Form 20 arrived. However, the arrival of the first Form 20 was in itself not particularly enlightening. That it was sold to an individual for an amount exceeding $97,000 was not unusual given that that was precisely why the exemption was created. For the five months running from February 1 to June 30, 1987, the Superintendent's file shows 18 Form 20's reflecting sales to 20 purchasers. It would not be alarming to note that 20 people bought promissory notes from a large corporation in a five month period.[4]

A more reasonable point at which the Superintendent might have reflected upon the sophistication of the investors is June 3, when both Mr. Sinclair and his assistant became aware that $15 to $20 million in PGL promissory notes were outstanding to B.C. investors.

Once again, however, it must be recalled that it was at this point reasonable for the Superintendent to await Alberta's decision for a limited period of time. It is the view of this office that the matter of the impending collapse of the Principal Group of Companies was properly viewed as an issue involving all the companies, because of their interdependency. This provides a reasonable explanation for the Superintendent's actions in neither cancelling the

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[4]One must always keep in mind that although PGL sold 136 notes between February 1 and June 27, 1987, the Superintendent's office was only notified on 20 of these.

registrations for AIC and FIC nor removing the exemptions of PGL.

On July 2, with the cancellation of AIC and FIC's licences, it is clear that some consideration should have been given to removing PGL's exemptions. However, as no PGL notes were sold in B.C. after June 30, 1987, the Superintendent's failure to consider removing PGL's exemptions did not cause financial loss to B.C. investors.

It is our opinion that the regulators did not act unreasonably with respect to their handling of the PGL note sales in British Columbia. We appreciate the tragedy of the losses suffered by the unsophisticated investors of PGL notes, but we cannot attribute their losses to actions or lack of actions on the part of the Superintendent of Brokers office. There was no statutory duty to regulate the sale of PGL notes and there was no substantive failure on the part of the Office of the Superintendent of Brokers or the British Columbia Securities Commission with respect to the marketing of PGL notes in British Columbia. This being the case, we cannot find that the government has a duty to compensate British Columbia investors in PGL notes.

Our investigation has revealed a situation whereby a company - PGL - was able to rely on the wording of the statute and thereby to take advantage of a group of people not contemplated by the legislators. PGL was able to do this in such a way that even the regulators for the most part were unaware of it. What our investigation has demonstrated is that the legislative assumption that possession of a specified minimum amount of money equals sophistication was, in this situation, incorrect.

As stated earlier, it is not the business of the Ombudsman's office to draft public policy, as this is properly the role of the legislators. It is the Ombudsman's role to investigate the administration of the statutes and in this instance we do not find fault with the Office of the Superintendent of Brokers.

Despite the preceding remarks, it is clear that this tragedy arose because of the failure in the statute and regulations, as they were drafted, to screen out unsophisticated purchasers. In these circumstances, we believe that this office can make useful recommendations such that the likelihood of future similar tragedies will be lessened. It is with this in mind that we propose the recommendations outlined in the next chapter.

VI. RECOMMENDATIONS

Our recommendations address two central observations that arise out of this investigation. First, a great number of PGL noteholders mistakenly believed that PGL was regulated by the provincial government and that because of this their investments would be secure. These investors seemed genuinely confused about the role played by provincial regulators. Second, it is clear that the legislators' intention that only sophisticated investors would be buying exempt promissory notes was frustrated.

With respect to the first observation, the government, as trustee of the taxpayers' money, has a responsibility to make the public aware of how its money is being spent. This is a fundamental principle of an accountable democracy. It must be appreciated that taxpayers' money helps pay for this province's regulatory regimes - such as the Office of the Superintendent of Brokers. Inasmuch as there appears to be considerable confusion over the role played by the provincial government in the field of financial regulation, it is important that government clearly state what it does and what it does not do. It would be unfair for government, once aware of this misplaced reliance, to remain silent while the uninformed continued to invest. As a result, we make the following recommendations:

RECOMMENDATION 1

The government should publish a pamphlet for widespread public distribution that would:

a) outline the general purpose of financial regulation and the role played by provincial regulators;

b) indicate to the consumers of financial products which of those products is regulated and by which level of government (i.e. federal or provincial);

c) emphasize the importance of consumers seeking professional advice where there are any concerns or questions with respect to a particular investment.

RECOMMENDATION 2

> **The government should establish a toll-free information line that consumers might call in order to get answers respecting the role of the provincial government in the regulation of financial products in British Columbia.**

Such a pamphlet and information line would ensure that an enquiring or confused investor at least had someone to whom he or she could direct questions. As well they would ensure that investors generally become better aware that "buyer beware" remains the general rule in the financial marketplace.

With respect to the second observation, the Securities Act S.B.C. 1985 and its Regulations should be reconsidered. We note that the $50,000 minimum investment amount specified for the purpose of short-term promissory notes was first introduced by Ontario in 1963. The consumer price index shows that a $50,000 investment made in 1963 would be equivalent to a $243,000 investment made in 1990. Yet B.C. still uses the 1963 amount. Similarly, the $97,000 figure first introduced in Ontario in 1978 for the purpose of long-term promissory notes sold to individuals (and adopted by B.C. in 1983) has an equivalent value in 1990 of $208,000. Yet B.C. still uses the 1978 amount.

Accordingly, we make the following recommendation:

RECOMMENDATION 3

> **The Securities Regulation which sets the minimum investment amounts should be reviewed periodically to take into account the changing value of money.**

But even if the minimum investment amount were raised that would not be enough, because our investigation has made it clear that while many PGL noteholders had the required minimum investment capital required by the Regulation, they did not have the "sophistication" that the legislators believed went with it. A review of the PGL note sales in B.C. makes this clear.

According to the PGL log, 602 short-term notes and 25 long-term notes were sold to individuals in B.C.

Of the 602 short-term notes,

> 395 (66%) had a face value between $50,000 and $74,999;
> 68 (11%) had a face value between $75,000 and $99,999;
> 86 (14%) had a face value between $100,000 and $149,999; and

53 (9%) had a face value in excess of $150,000.

Of the 25 long-term notes,

19 (76%) had a face value between $97,000 and $149,999;
1 (4%) had a face value between $150,000-$199,999;
3 (12%) had a face value between $200,000-$249,999; and
2 (8%) had a face value over $250,000.

This information demonstrates that raising the minimum investment amount will not by itself ensure that only sophisticated investors purchase exempt promissory notes.

If the government seriously wishes to avoid the recurrence of a tragedy similar to that of the PGL noteholders then our analysis shows that it must go further than simply raising the minimum investment amount. It must ensure that at the time of sale a potential investor of exempt promissory notes is, at least, aware of the fact that his or her investment has not been reviewed by a government agency and that no insurance is in place on it. Had the supposedly sophisticated PGL noteholders been made aware of the nature and degree of risk of their investment prior to, or at the time of, sale they would likely not have purchased. Because of this we make the following recommendations:

RECOMMENDATION 4

Section 32(d) of the Securities Act governs the sale of short term promissory notes. It contains limitations on which kind of notes can be sold; for instance the term may not exceed 12 months and if the sale is to an individual it must be for at least $50,000 (the "prescribed amount" found in the Regulation). We recommend that the legislation be amended to add a third subsection (iii) which would introduce a further limitation where short term notes are to be sold to individual investors. Section 32(d) would then read:

> 32. Except to the extent required by the regulations, a person may trade in the following securities without being registered under section 20(1) ...
>
> (d) negotiable promissory notes or commercial paper maturing not more than 12 months from the date of issue so long as
> (i) each note or commercial paper is not convertible or exchangeable into or accompanied by a right to purchase another security other than a

security described in this section, and

(ii) each note or commercial paper traded to an individual has a denomination or principal amount of not less than a prescribed amount, and

(iii) each note or commercial paper traded to an individual states:

This security is being sold under an exemption from registration and prospectus requirements of the Securities Act. No Securities Commission or similar regulatory authority has passed on the merit of this security and any representation to the contrary is an offence. No government or other insurance is in place on this security.

Alternatively, we recommend that consideration be given to disallowing the sale of exempt short term promissory notes to individuals altogether.

RECOMMENDATION 5

The Securities Act and Regulation presently require that where a long term note is being sold to an individual, the issuer of the note file a Form 20 with the Securities Commission. The Form 20 contains ten sections and is signed by an authorized signatory of the issuer. As this Form is already in use, and in order to better protect long term investors, we recommend that it be amended to include a further provision as follows:

11. If the distribution was under s.55(2)(4) of the Securities Act the purchaser, if an individual, was advised in writing at the time of sale that the security was being sold under an exemption from registration and prospectus requirements of the Securities Act and that no Securities Commission or similar regulatory authority had passed on the merits of the security and that no government or other insurance was in place on the security.

RECOMMENDATION 6

The Securities Act contains provisions allowing for a "cooling off" period of 2 business days in the case of some securities sales. However, this cooling off period only applies when purchasers have been provided with a prospectus. This cooling off period gives the purchaser an opportunity to rescind the purchase. Yet in the case of exempt promissory note sales where no information need be provided, there is no cooling off period.

Accordingly, we recommend that a "cooling off" period of two (2) business days be provided to individual purchasers of exempt promissory notes.

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